S. HRG. 102-83

CONGRESSIONAL BUDGET OFFICE ESTIMATED RECAPITALIZATION OF THE BANK INSURANCE FUND

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

THE CONDITION OF THE BANK INSURANCE FUND [BIF] AND THE CONGRESSIONAL BUDGET OFFICE [CBO] LATEST BASELINE PROJECTIONS OF THE FUND'S SPENDING AND CBO'S ASSESSMENT OF ITS FINANCING NEEDS

JANUARY 29, 1991

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CONGRESSIONAL BUDGET OFFICE ESTIMATED RECAPITALIZATION OF THE BANK INSURANCE FUND

TUESDAY, JANUARY 29, 1991

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:05 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order. Let me welcome all those in attendance this morning.

We're pleased to have back before us Dr. Robert Reischauer, who is the Director of the Congressional Budget Office. Some of you who were here then will remember that September 12, 1990, Dr. Reischauer told this committee that "The Bank Insurance Fund was," and I quote him, "very vulnerable."

Presenting the CBO's analysis, Dr. Reischauer told the committee that the BIF's outlays, the Bank Insurance Fund's outlays, would continue to exceed its income. And, "In particular," he noted that the Fund, and I quote him again, "could easily run out of cash if a weaker economy or other factors produce continued substantial losses. The failure of one of the very large banks could by itself deplete the Fund." End of quote.

In response to that testimony in a similar analysis that was submitted to us the previous day by the General Accounting Office, I thereupon introduced and this committee reported legislation that enabled the FDIC to have new authority to replenish the Fund by increasing the deposit insurance premiums that it applies to insured commercial banks.

And that legislation was enacted into law as part of the Omnibus Budget Reconciliation Act of 1990. So, that legal authority provided the FDIC with the ability to be able to adjust the deposit insurance premiums to try to build up enough of a surplus in the Fund to head off anticipated additional losses.

Now, the other side of that coin is there are limits as to how much the insurance premiums can be raised without creating by themselves a problem for the banks that the banks can't handle.

Since that time, and it's only been just a few months, several things have changed. A large bank, the Bank of New England, failed earlier this month. Economic conditions generally have also

deteriorated over that time period. GNP declined in the fourth quarter of 1990 at the annual rate of over 2 percent, and the anticipation by the Congressional Budget Office is that we'll see another down-quarter in terms of the economic calendar quarter that we're in at the present time.

And, certainly, we all know that the war in the Persian Gulf is affecting America's economy in ways that we are only beginning to understand and be able to take account of.

So, all of these things make it appropriate for the committee to visit again with Dr. Reischauer to question the condition of the Bank Insurance Fund. And, this morning, he will present CBO's revised assessment of the strength and condition of that Fund.

He will also discuss alternatives for strengthening the Fund. And, in that area, several questions arise.

First of all, not only how much is needed to recapitalize the Bank Fund, but where it should come from, who should actually pay for this recapitalization.

Second, how much can the banking industry afford to pay, and how should those costs be distributed within the industry itself?

Third, a very important point, does he anticipate taxpayer money will be needed to shore up the Fund?

And, finally, should the FDIC continue to close or sell failed banks, or should it provide more open bank assistance as the Reconstruction Finance Corporation did during the 1930's?

I think this is now an issue that is before us. And that is:

Is there some way that we ought to try to work this problem through short of actually having banks fail one after the other and then deal with the aftermath of a shutdown.

I want to thank our witness today for the assistance that you and your staff have provided to the committee over the past year. You've been very helpful to us, always responsive. And we appreciate that very much.

Let me now go to my colleagues. I think Senator Gramm arrived just a little bit ahead.

Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Well, Mr. Chairman, let me begin by thanking you for holding these hearings. I think this committee and the Congress learned a great lesson from our problems in the savings and loan industry. I don't think it serves any purpose to go back and pound our chests as to what we individually did or didn't do.

But I think the bottom line is that the taxpayer lost billions of dollars because of inaction, because we did not act quickly enough in providing the resources that were needed to close failed thrifts. We let the problem continue to limp along and the result, we all know, was catastrophic.

I think it is very important that we not allow that problem to be reproduced in the banking system. And I am confident, in fact, because of a painful learning process, that that will not be the case.

Let me also say, Mr. Chairman, that I want to congratulate Bob Reischauer. It is very difficult, it seems to me, to be Chairman of

the Congressional Budget Office when one party controls both Houses of Congress.

I think, under those circumstances, it's very difficult to maintain objectivity and I think, Bob, you've done an outstanding job of doing that. And I just wanted to take this opportunity to congratulate you on it.

Mr. Chairman, I think it's very important that we hold these hearings. I think it's important that we act quickly. I think we all know that we have problems of liquidity and financial strength in the banking system. I think we're all dedicated to try to minimize the cost involved. And I just want to congratulate you on your leadership in holding this hearing and addressing this problem head-on.

The CHAIRMAN. Thank you, Senator Gramm.

Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you, Mr. Chairman.

Mr. Reischauer, welcome.

The Bank Insurance Fund, obviously, has severe problems, Mr. Chairman, and I'm very pleased that we're moving rapidly on this. I hope we can work our way through to solving this without ending up with enormous taxpayer exposures. We've been through all of that, obviously, with the S&L industry. We certainly want to set it up in such a way that the burden of this gets shared more equitably than we have in the past.

I thank you for doing this.

Mr. Reischauer, again, thank you for your dedication and commitment. I appreciate it.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Wirth.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, first, I'd like to join with my colleagues and thank you for scheduling these hearings and, of course, most of all, welcoming Bob Reischauer back to the committee. Bob Reischauer was a witness before us just last September.

Bob, I've got to tell you, I don't know which of the chairman's motivation it is—either he wants you to do an encore of your previous appearance, or he's keeping you here, inviting you back again and again until you get it right. [Laughter.]

But, in either case, we all know that the Congressional Budget Office, with which you head with such distinction, will be most helpful if you help us avoid a repeat of what we've been through with the savings and loan crisis.

Although your testimony wasn't available until I guess very early this morning or very late last night, I gather that the lyrics of your testimony may have changed, but the tune is familiar.

And what we are confronting, of course, is a Bank Insurance Fund with reserves at an all-time low. We know about the weakening of the industry in real estate, the highly leveraged transactions, the LDC's. All of these have contributed to industry losses.

While the need to bolster the Insurance Fund is clear, some observers doubt the capacity of the industry to do it. While no one is playing some kind of industry death march, nonetheless, Bill Seidman, particularly as quoted in this morning's paper, is certainly singing the blues. I hope that the taxpayers don't have to sing along with him where the Bank Insurance Fund is concerned.

Mr. Chairman, I think there are three things we need to bear in mind throughout all this.

The first is that Congress can obviously not fiddle while potential losses in the banking industry threaten to burn a hole through the Bank Insurance Fund.

Second, we've got to make sure that there are enough funds to close insolvent banks at the earliest and, prevent those weak banks from generating additional losses.

Third, we've got to put into place a new deposit insurance system that not only protects depositors, but taxpayers as well. The S&L crisis, and the current problems of the Bank Insurance Fund present clear and convincing evidence of the need for deposit insurance fund and the need to take action sooner, not later.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Heinz.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, obviously, today's hearing is important. We thank you for attempting to stay ahead of the curve. It relates to just what the Fund level will be, what the need for recapitalization is. We recognize that it's precariously low, the Fund. And the question comes to how best to meet those needs, to do what has to be done, and, yet, to do it in a manner that does not destroy any opportunity of the banks to be able to be profit centers so that they can, indeed, continue their business. And, hopefully, provide the resources to deal with the very low Fund balances that are in existence.

Chairman Seidman says that for every $100 in insured deposits there's only approximately 46 cents in reserves. He goes on to say that: "Reserves are expected to drop as low as 18 cents in 1991."

So, even without a recession, the Bank Insurance Fund is obviously weakening under the strain of increased bank resolutions.

And the question is whether the BIF, the Bank Insurance Fund, can be recapitalized before it collapses and whether it can be done without involving taxpayers' money.

How do we do it?

Is this a time for new legislation that can encourage an infusion of capital? I think we've got to look to that, not look to some broken down old system to say just let them do more business.

I wonder how it is with banks in such a precarious position that the regulators at some times have allowed banks to bail out parent corporations. I wonder where they could ever come up with that kind of theory.

One of the things that has just recently been approved here in the Washington, DC. area, absolutely mind-boggling, how the regulators could come up with that.

And I think, Mr. Chairman, we ought to look into that. Imagine the banking system bailing out the parent corporation. That's exactly, you know, why have firewalls if you're going to go right through them?

So, we certainly look forward to your testimony because I don't think that we can allow the same kind of situation to take place that did take place previously as it related to the thrifts.

If we're going to go to the taxpayers for money, I think they're going to begin to say:

Why should we be engaged in this kind of business?

We set up funds to insure. Then we come back and it's the taxpayer who is looked to for the ultimate resolve.

So I'm very much concerned, and I look forward to your testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Very good. Senator Domenici.

Senator DOMENICI. Mr. Chairman, I think I will just ask you to put my statement in the record so we can proceed.

The CHAIRMAN. Very good. We'll make it a part of the record.

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Dr. Reischauer, it is a pleasure to see you before another committee for a change. You have a very difficult task here today. Estimating losses for the banking industry is like hitting a moving target.

Combining the factors of a sluggish economy, a rapidly deteriorating banking industry, weak real estate markets, and the impact of a war on bank industry loss estimates must be challenging. It must be particularly difficult knowing Congress and the press will rely on these estimates as fact.

The task before the committee this year is very difficult as well. Clearly BIF needs to be recapitalized and we need to address replenishing the Fund in this session of Congress. BIF cannot wait. Our task is to find the balance between protecting the taxpayers from another banking bailout, without crippling the banking industry.

CBO PRELIMINARY BASELINE: FINANCIAL SOUNDNESS OF BIF

I find it most startling how dramatically CBO estimates of BIF have changed since you testified before this committee in September. Within a 5 month period, BIF outlays have increased by $10 billion for fiscal year 1991.

If I understand Dr. Reischauer's testimony, BIF is being depleted of revenue rapidly by bank failures. Despite the deterioration of the banking industry, CBO projects BIF has enough revenue to cover losses for fiscal year 1991. However, BIF will not be able to cover its losses beyond this year without a cash infusion.

Clearly serious problems exist for BIF and it is in the midst of a downward slide. Congress needs to respond to these warning signs

and recapitalize BIF. We cannot let our own inaction cause further deterioration.

BUDGET AGREEMENT

When I hear how BIF numbers have skyrocketed in just 5 months, it may be of some solace to this committee that BIF was given special treatment in the budget agreement.

While the deficit amount includes BIF outlays, the budget agreement excludes BIF from sequestration. This means $10 billion fluctuation in CBO estimates for BIF will not trigger or prevent a sequester, but will increase the deficit calculation.

If Congress upholds the budget agreement there will be no need for a reconciliation bill this year. Increasing BIF premiums is being driven by the need to keep BIF solvent and funded at a level necessary to meet the needs of a healthy and orderly banking system.

Under the new pay-as-you-go procedures, BIF premiums will not count under the congressional scorecard to meet existing liability commitments. However, if BIF liabilities are expanded, then the liability will have to be offset to prevent a sequester to other programs.

The budget agreement has potentially expanded CBO's role in providing cost estimates of deposit insurance legislation. Under pay-as-you-go, CBO will determine whether the Government's exposure has been expanded and if an offset is adequate. These cost estimates could drive the policy debate for a deposit insurance bill.

CONCLUSION

It is clear that some form of assistance will be required to recapitalize the Bank Insurance Fund. I understand there are many different ways of doing this, but that is not the purpose of this hearing.

CBO is just being the messenger of bad news, but the real challenge lies with this committee to recapitalize the Insurance Fund.

The CHAIRMAN. Dr. Reischauer, I think, as you can tell from the initial comments, you're welcome here and we're very interested in your views. Why don't you proceed?

STATEMENT OF ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. REISCHAUER. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to appear before you today to discuss the condition of the Bank Insurance Fund and some related issues.

With your permission, I'll submit my prepared statement for the record and confine my remarks to a summary of CBO's latest estimates.

The CHAIRMAN. Very good.

Mr. REISCHAUER. Let me start by saying a few words about the current——

The CHAIRMAN. If you could pull the mike just a little closer. I want to make sure everybody in the back of the room hears you well.

Mr. REISCHAUER. OK. Let me start by saying a few words about the current condition of the banking industry. I do this because the resources that are ultimately available to the Fund from the industry, as opposed to resources from the taxpayer, depend on the industry's long-run financial condition.

In the aggregate, the U.S. banking industry appears to be relatively healthy. Over the past decade, net income of commercial banks as a percentage of total assets has been fairly stable at about 0.7 percent, while the capital-to-asset ratio of commercial banks and savings banks as a group has actually increased from 5.8 percent in 1980 to 6.5 percent in the second quarter of 1990.

These encouraging aggregate statistics, however, mask a division within the banking industry. On one side lies the large majority of banks, those that are well capitalized and are earning money. In the first three quarters of 1990, almost 11,000 of the Nation's 13,000 banks had equity-to-asset ratios of more than 6 percent and reported positive net income. These banks held nearly half of the industry's assets.

On the other side lies a small proportion of banks, those that are poorly capitalized and losing money. Fewer than 600 banks with equity-to-asset ratios of less than 6 percent reported net losses for the first 9 months of 1990. These institutions accounted for only about one-tenth of the industry's total assets.

With this information setting the context, let me now turn to CBO's estimates of the Bank Insurance Fund's contingent liabilities and CBO's baseline projections for the Fund.

Our latest estimates are more pessimistic than those that I shared with this committee in early September 1990. The projections of the Fund's contingent liabilities, which I discussed in September, indicated that the Fund would have losses of about $21 billion over the 3½ year period that began in January 1990. Our current estimate suggests losses of close to $30 billion over the 3½ year period that began in July 1990. The major reason for the increase in the estimated losses is the recession, which we assume would reduce equity-to-asset ratios by an average of three-quarters of a point. In addition, some of the increase is attributable to the premium increases we have assumed, which raise the Fund's net income but also add to the number of bank failures.

Like any projection of the Fund's losses, CBO's estimates are subject to many uncertainties, prime among them being the health of the Nation's economy. To get a feel for the importance of this uncertainty, we tested the sensitivity of our baseline projections to differing assumptions about the economy.

What we found was that, if the recession is slightly more severe than CBO now expects—and we have assumed a relatively mild recession—then the losses of the Fund could be $1 billion to $2 billion a year greater than in our set of estimates. A more severe recession could boost outlays and net losses by an average of $6 billion to $7 billion a year over this period. And, of course, the biggest impact would be in 1991 and 1992.

CBO's latest baseline projections for the Bank Insurance Fund estimate that gross spending by the fund will rise from $13 billion in fiscal year 1990—that's last year—to almost $22 billion in 1991 and about $16 billion in 1992. Then, it will drop relatively sharply

for the subsequent 3 or 4 years. This spending would cover losses on bank resolutions of $13 billion in 1991, $9 billion in 1992, and somewhere between $4 billion and $6 billion a year for the following few years.

Because the Fund would not have adequate resources to cover expenditures of this magnitude at the current assessment rate, which is 19.5 cents per $100, our projections have assumed further increases. Specifically, we've assumed that assessments will rise to 23 cents per $100 on July 1, 1991; to 27 cents on January 1, 1992; and then to 30 cents on January 1, 1993.

Even with such premium increases, the Fund would incur net losses of about $13 billion over fiscal years 1991 through 1993. The accrued Fund balance, which was $10.5 billion on September 30, 1990, would almost disappear by the end of 1991, and the Fund would be insolvent early in fiscal year 1992. The Fund's cash balances would also be depleted early in fiscal year 1992. CBO, therefore, has assumed that the Fund will borrow about $11 billion from either the Treasury or the Federal Financing Bank (FFB) in order to meet its cash needs.

While CBO constructed its baseline assuming that the Fund could borrow from the Treasury or the FFB in an unconstrained manner, under existing law the Fund's borrowing is limited, and these limitations would prevent it from resolving all of the banks that are projected to fail over the next 3 years. Therefore, some steps must be taken to ensure that a cash shortfall does not delay the closure of failed banks and drive up the ultimate cost of resolution, as has happened in the savings and loan debacle.

One option to meet the immediate need would be to grant the Federal Deposit Insurance Corporation [FDIC] the additional authority to borrow, such as we have assumed in the CBO baseline. While borrowing of this sort would require repayment with interest, it would permit the Fund to meet its obligations over the next few years while allowing the industry a longer time to cover those costs with its premium payments.

A second alternative would be to recapitalize the Fund; that is, to provide it with an infusion of money that was not repayable. This could be accomplished through an increased premium levy on insured banks, a special one-time assessment, or a subvention from the Treasury. Such a strategy might be appropriate if the Fund's insolvency were viewed as being more permanent in nature.

Since both the Fund's liabilities and the future condition of the banking industry are somewhat uncertain, a middle of the road option would be to use added borrowing authority to get through this difficult period, and then to have a recapitalization take effect later when the extent of the problem is known and the industry is likely to be in slightly better health.

Let me close with a word of caution about the relevance of banking reform to the problem of the Fund's solvency. While any new legislation dealing with banking powers could have significant long-term effects on the Fund, the Fund's immediate liquidity needs cannot be met through regulatory reforms. To avoid a cash shortage that would delay necessary bank closures, the FDIC must have added resources soon. Expanding the Fund's ability to borrow from the Treasury or the FFB would solve this immediate liquidity

problem. Once that is done, there will be sufficient time to determine the best way to recapitalize the Fund over the long haul, should a more permanent funding source be needed. That decision could be made in conjunction with consideration of deposit insurance reform and other banking regulatory reforms that are on this committee's long-term agenda.

Let me just say in closing that my staff and I look forward to working with this committee and the committee's staff as you work on this very difficult set of problems.

[The complete prepared statement of Robert D. Reischauer follows:]

CBO TESTIMONY

Statement of
Robert D. Reischauer
Director
Congressional Budget Office

before the
Committee on Banking, Housing,
and Urban Affairs
United States Senate

January 29, 1991

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Tuesday, January 29, 1991.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman, I appreciate this opportunity to appear before your Committee to discuss the condition of the Bank Insurance Fund (BIF). I will share with you the Congressional Budget Office's (CBO) latest baseline projections of the fund's spending and our assessment of its financing needs.

RECENT DEVELOPMENTS

Since I testified before this Committee in September, a number of developments have significantly affected the outlook for the banking industry and the Bank Insurance Fund. These include the changed outlook for the economy, the continued deterioration in real estate prices, the decline in bank profits, the growing losses of the Bank Insurance Fund, and the legislation enacted at the end of the 101st Congress. Let me elaborate on each of these developments.

- The economic outlook is now gloomier. As do most forecasters, CBO believes that the U.S. economy is now in its ninth recession of the postwar period. We expect the recession to end by the middle of 1991 and to be followed by a period of solid economic growth and reduced inflation. CBO's latest economic forecast calls for real gross national product to grow about 1.3 percent between the fourth quarters of 1990 and 1991. This growth rate is considerably lower

than the 2.5 percent we predicted last summer. Pressures on banks to increase the overall quality of their assets and strengthen their capital ratios could work to slow the recovery by restricting the supply of credit.

- The weakness in regional real estate markets appears to be intensifying and spreading from the Northeast down the Atlantic coast and to the West. Recent surveys indicate that realtors believe that real estate values will continue to fall through 1992 or 1993 and, even worse, could remain depressed for up to five years. Banks are particularly vulnerable to losses on their commercial real estate loans; these loans grew from 5.4 percent of bank assets in 1980 to 10.7 percent in mid-1990. A recent study by Salomon Brothers predicted that commercial real estate prices will decline by 10 percent to 30 percent in the coming year and that the amount of vacant office space now available in the United States could satisfy demand for new space for the next 10 years. Consequently, owners of such properties may have increasing difficulty in paying off their bank loans.

- Bank earnings continue to be weak. In the third quarter of calendar year 1990, commercial banks earned $1.6 billion, or 29 percent, less

than in the second quarter. They set aside $8.3 billion in provisions for loan losses and recorded net loan charge-offs of $6.1 billion. While fourth-quarter figures are not complete, initial reports indicate a number of large banks with growing loan losses and diminishing earnings, primarily attributable to real estate loans.

o Fiscal year 1990 was BIF's worst year ever. Outlays were $6.4 billion, and its net losses totaled $3.5 billion. By comparison, from 1980 through 1988, the fund averaged net budgetary receipts of $0.6 billion and net income of $0.9 billion annually. Fiscal year 1991 shows no improvement. In the past few months, the Federal Deposit Insurance Corporation (FDIC) has continued to resolve failed and troubled institutions at a historically high rate, including the Bank of New England, which by itself the FDIC estimates will cost over $2 billion. The FDIC's inventory of assets being liquidated by receiverships is continuing to grow. At the end of October 1990, the FDIC reported a total of $16.7 billion in assets obtained in resolving failed banks. To help cover the growing costs of bank failures, the FDIC raised the premium paid by banks to 19.5 cents per $100 of insured deposits, as it had previously proposed.

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- The Congress enacted and the President signed into law the Omnibus Budget Reconciliation Act of 1990. The new law removes the existing ceilings on BIF premiums and allows the FDIC to increase premiums as often as twice a year. This legislation also provides the FDIC with new authority to borrow from the Federal Financing Bank as long as the net worth of the fund is at least 10 percent of the market value of its assets.

CURRENT CONDITIONS IN THE BANKING INDUSTRY

Despite recent losses, the U.S. banking industry appears relatively healthy overall. Net income as a percent of total assets has been fairly stable during the past decade at around 0.7 percent for commercial banks. The capital-to-asset ratio of commercial banks and savings banks as a group has increased from 5.8 percent in 1980 to 6.5 percent in the second quarter of 1990.

Underlying these encouraging figures are really two separate banking industries. One, which comprises a large majority of banks, is well capitalized and earning money. The other, encompassing only a small proportion of banks, is poorly capitalized or losing money or both. For example, in the first half of 1990, almost 11,000 of the 13,000 banks had equity-to-asset ratios of

more than 6 percent and reported positive net income. These banks accounted for nearly half of the industry's assets and show every sign of being able to survive the recession we believe is currently under way.

At the other end of the spectrum are fewer than 600 banks with equity-to-asset ratios of less than 6 percent that reported net losses for the first six months of 1990. These institutions account for only about one-tenth of the industry's assets, and many of them are likely to fail by the end of 1993.

A number of large banks are vulnerable to an economic downturn. Through 1985, nonperforming loans were roughly 2 percent of assets for the largest banks--those with assets of more than $10 billion. That figure rose to 2.5 percent on average for the last half of the decade. The difficulties have grown during this past year for many of these very large banks. For example, their nonaccruing real estate and commercial loans have increased, as a percentage of equity, from 60 percent in December 1989 to 72 percent in September 1990.

BASELINE PROJECTIONS FOR THE BANK INSURANCE FUND

In September, CBO projected that BIF's net outlays would peak in fiscal year 1990 and then decline gradually over the next five years. At that time, we indicated that the estimates did not take into account the slower economic growth that then seemed likely. Because of the recession and the real estate slump, we now expect BIF's losses to be substantially greater than we previously estimated, particularly over the next two to three years. Our latest baseline projections for the Bank Insurance Fund are summarized in Table 1.

We now estimate that gross spending by the fund will rise from about $13 billion in fiscal year 1990 to almost $22 billion in 1991 and about $16 billion in 1992, before dropping off sharply in subsequent years. This spending would cover losses on bank resolutions of $13 billion in 1991, $9 billion in 1992, and $4 billion to $6 billion a year for the following few years. (The difference between gross spending and the losses on bank resolutions consists primarily of working capital to cover the cost of acquired assets, but also interest on notes issued to acquiring institutions as well as administrative expenses.)

TABLE 1. FINANCIAL PROJECTIONS FOR THE FDIC BANK INSURANCE FUND
(By fiscal year, in billions of dollars)

	Actual 1990	1991	1992	1993	1994	1995	1996
Outlays							
Gross Spending[a]	12.8	21.8	15.7	11.0	9.3	9.3	7.9
Collections	-6.4	-9.3	-11.9	-13.6	-13.2	-13.4	-13.6
Net Budget Outlays[b]	6.4	12.4	3.9	-2.7	-3.9	-4.0	-5.7
Accrued Income or Losses							
Gross Losses[c]	-7.2	-13.0	-9.0	-6.0	-5.0	-5.0	-4.0
Net Income or Losses[d]	-3.5	-9.1	-4.2	0.2	1.6	1.9	3.3
End-of-Year Balances							
Cash Balance[e]	8.6	1.1	-5.1	-4.8	-1.4	2.6	7.8
Accrued Fund Balance	10.5	1.4	-2.8	-2.6	-1.0	0.9	4.2

SOURCE: Congressional Budget Office.

NOTE: FDIC = Federal Deposit Insurance Corporation.

a. Includes cash disbursed and notes issued for bank failures, plus other cash expenditures. Excludes interest on assumed borrowing from the Treasury or the Federal Financing Bank.

b. Gross spending less collections. Excludes interest on assumed borrowing from the Treasury or the Federal Financing Bank.

c. Losses accrued in resolving failed banks.

d. Assessment income and interest earnings less gross losses and other expenses. Excludes interest on assumed borrowing from the Treasury or the Federal Financing Bank.

e. Excludes amounts borrowed from the Treasury or the Federal Financing Bank.

At the current assessment rate, BIF would not have adequate resources to cover expenditures of this magnitude. CBO's projections, therefore, assume further premium increases--to 23 cents per $100 of assessable deposits on July 1, 1991; to 27 cents on January 1, 1992; and to 30 cents on January 1, 1993. These levels are somewhat arbitrary in that we do not know what the FDIC is contemplating, but we believe that they are reasonable.

Even with such premium increases, the fund would incur net losses of about $13 billion over fiscal years 1991 through 1993. The accrued fund balance, which was $10.5 billion on September 30, 1990, would almost disappear by the end of 1991, and the fund would be insolvent by early in fiscal year 1992. BIF's cash balances would also be depleted by early in fiscal year 1992. CBO therefore assumed that the fund would borrow about $11 billion from either the Treasury or the Federal Financing Bank (FFB) in order to meet its cash needs. Under our baseline assumptions, BIF would be able to repay this amount by 1996.

These projections reflect a number of different approaches and sources of information. One important analysis was an update of CBO's projection of BIF's contingent liabilities, using the probabilities of failure and loss rates experienced from 1986 to mid-1989 by institutions of different sizes and ratios of equity to assets. In September 1990, this type of analysis suggested BIF

losses of about $21 billion over a 3 1/2-year period beginning in January, 1990.

Our current estimate suggests losses of close to $30 billion over the 3 1/2 years from July 1990 through December 1993 (see Table 2). Much of this increase is the result of the recession, which we assumed would reduce equity-to-asset ratios by an average of 0.75. This adjustment reflects the fact that a weak economy would increase the likelihood of bank failures by increasing loan defaults and reducing bank earnings. The amount of the adjustment is less than the sharp reduction in the equity-to-asset ratios of Connecticut and Massachusetts banks that occurred between mid-1989 and mid-1990, and is intended to project the effect of a somewhat milder economic downturn than has been experienced in New England. The remainder of the increase in BIF's projected gross losses stems from the assumed premium increases, which raise net income by bringing in substantial amounts of additional receipts, but also add to the number of bank failures.

CBO's projection of losses for 1991 is slightly greater than what William Seidman, Chairman of the FDIC, estimated in December. In testimony, he indicated that BIF would incur losses on failed institutions of about $10 billion during calendar year 1991; on a calendar year basis, CBO's projection is about $12 billion.

TABLE 2. PROJECTION OF 1990-1993 BANK INSURANCE FUND LOSSES BASED ON THE 1987-1990 EXPERIENCE

	Number of Insured Banks June 30, 1990	Total Assets June 30, 1990 (Billions of dollars)	Projected Number of Failures July 1990-December 1993	Projected Fund Losses, July 1990-December 1993 (Billions of dollars)
Group 1				
Large banks	524	1,138	14	2.8
Medium banks	2,344	456	62	3.6
Small banks	8,855	341	237	4.6
Total	11,723	1,934	313	11.0
Group 2				
Large banks	189	1,535	25	11.3
Medium banks	219	52	31	2.0
Small banks	594	23	86	1.4
Total	1,002	1,609	142	14.6
Group 3				
Large banks	6	7	4	0.3
Medium banks	14	2	9	0.2
Small banks	83	3	54	0.3
Total	103	13	67	0.8
Group 4				
Large banks	5	27	3	1.6
Medium banks	13	3	8	0.4
Small banks	45	1	27	0.2
Total	63	31	38	2.2
Group 5				
Large banks	2	2	2	0.3
Medium banks	2	0	2	0.1
Small banks	33	1	32	0.4
Total	37	4	36	0.8
Total, All Groups	12,928	3,591	596	29.4

SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation and Ferguson and Co.

NOTES: The banks are grouped by equity as a percentage of assets, as follows:

Group 1	Greater than 6 percent
Group 2	Greater than 3 percent, but less than or equal to 6 percent
Group 3	Greater than 1.5 percent, but less than or equal to 3 percent
Group 4	Greater than zero percent, but less than or equal to 1.5 percent
Group 5	Less than or equal to zero percent

Banks with assets of at least $500 million are categorized as large; banks with assets greater than $100 million and less than $500 million are categorized as medium; banks with assets of $100 million or less are categorized as small.

CBO's estimates are similar to those of three banking analysts--James R. Barth, R. Dan Brumbaugh, Jr., and Robert E. Litan--who prepared a report in December for a subcommittee of the House Committee on Banking, Finance, and Urban Affairs. They estimated that losses on failed institutions in the event of a mild recession would be in the range of $19 billion to $43 billion over a three-year period; CBO's baseline losses are slightly below the middle of their range.

UNCERTAINTIES IN ESTIMATING

Any projection of BIF losses is subject to vast uncertainties. BIF losses are very sensitive to the economy in general and to real estate markets in particular. How promptly regulators close failing banks, how they deal with troubled large banks, and how high they set deposit insurance premiums all have significant effects on BIF losses. The fate of a number of very large banks, some of which are currently in jeopardy, can swing the results substantially in either direction.

Finally, I should note that the data on which we base our projections leave much to be desired. Bank financial statements show the book value of their assets, which does not accurately reflect their current value. Bank

earnings reflect the institutions' judgments as to what losses to record and when. Because it takes years to sell assets, even the loss rates on resolutions that have already occurred are only estimates and will not be known for certain for many years.

To assess some of the variability of CBO's estimates, we have tested the sensitivity of our baseline projections to differing assumptions about the economy. The results are summarized in Table 3. A modest variation in the severity of the recession could increase or decrease outlays and net income

TABLE 3. PROJECTED SPENDING, LOSSES, AND BORROWING OF THE BANK INSURANCE FUND OVER FISCAL YEARS 1991-1994 UNDER DIFFERENT ECONOMIC ASSUMPTIONS[a]
(In billions of dollars)

	Gross Spending	Budget Outlays	Gross Losses	Accrued Net Income	Projected Borrowing Requirement
Baseline	58	10	33	-12	11
Milder Recession	50	3	28	-6	6
Moderate/Severe Recession	68	17	39	-18	18
Severe Recession	92	37	55	-34	38

SOURCE: Congressional Budget Office.

a. Assumes premium increases to 23 cents per $100 of assessable deposits on July 1, 1991; to 27 cents on January 1, 1992; and to 30 cents on January 1, 1993. Spending and losses exclude interest on assumed borrowing.

of the fund by an average of $1 billion to $2 billion a year over the 1991-1994 period. A severe recession could boost outlays and net losses by an average of $6 billion to $7 billion a year over this period. The biggest effects would occur in 1991 and 1992.

FUNDING NEEDS OF THE BANK INSURANCE FUND

CBO's assessment indicates that, within a year or so, the fund will be out of cash and insolvent without some form of cash or capital infusion. For our baseline, we have assumed that the cash shortfall of BIF would be covered by borrowings from the Treasury or the FFB, which we assumed to be unconstrained. Within the five-year period that our baseline covers, BIF should be restored to solvency and be able to repay its borrowings, assuming premium increases of the magnitude CBO has assumed.

Under existing law, BIF can borrow from the Treasury, the FFB, or other sources, but such borrowing is limited. BIF may borrow up to $5 billion from the Treasury without restriction, and may borrow from the FFB or other sources only if it is solvent and maintains a ratio of net worth to assets of at least 10 percent. These limitations on its borrowing authority would prevent BIF from resolving all of the failed banks projected in our baseline over the

next three years. Therefore, if losses are similar to or greater than those projected in our baseline, the fund's current borrowing authority would not be sufficient to cover its cash needs.

How this prospective shortfall is best met depends on the answers to a few key questions:

- Who should pay for the losses that BIF is incurring during this period--the banking industry (including those who use its services), the taxpayer, or some combination of the two?

- Are BIF's prospective financial difficulties temporary or long term?

- To the extent that the industry bears the costs, how should its contribution be timed and structured so as to minimize further disruption?

For the long run, a central issue is whether or not the banking industry can provide the necessary resources. Under the assumptions used for CBO's baseline, which have premiums rising to 30 cents per $100 of assessable deposits, assessments paid by the banking industry could cover BIF's aggregate financing needs over the next several years. They would, however, be

insufficient to cover the heavy losses we anticipate during the first part of this period. They would also fall far short of providing a reserve equal to 1.25 percent of insured deposits, as mandated by law.

At a minimum, some temporary financing seems to be needed immediately. This financing could be provided by granting the FDIC additional authority to borrow from the Treasury or removing the restriction that limits its line of credit. Borrowing, which would require repayment with interest, would permit BIF to meet its obligations over the next few years, while allowing the industry a longer time to cover those costs with its premium payments.

Alternatively, if the insolvency is viewed as being more permanent, BIF can be "recapitalized"--that is, provided an infusion of money that is not repayable. This recapitalization could occur through an increased premium levy on insured banks, a special one-time assessment, or a subvention from the Treasury. If banks are unable to recapitalize BIF, there would appear to be little alternative to calling on the resources of the Treasury--that is, the taxpayers--for more permanent funding.

Since BIF's liabilities and the condition of the banking industry over the next few years are so uncertain, one option would be to use added borrowing

authority to get through this difficult period and to have a recapitalization take effect later, when the industry is likely to be healthier.

We have identified several proposals, which are essentially variations of a single theme, that would recapitalize BIF with funds from the banking industry. These range from increasing premiums to placing a direct one-time call on the banking industry that would increase BIF's net worth. Some of the differences among the proposals concern the timing of the call on the banking industry to recapitalize BIF. Others involve how funds provided by banks would be treated on their balance sheets.

Let me note that how such proposals would affect the government's budget is now much less important than it used to be. The Budget Enforcement Act of 1990 eliminated the fixed deficit targets that caused such great concern over the budgetary impact of legislation financing savings and loan resolutions. The act also excludes from the new pay-as-you-go procedures legislation providing for "full funding of, and continuation of, the deposit insurance guarantee commitment in effect on the date of enactment." Thus, legislation providing funding for BIF cannot trigger a sequestration, nor would it necessitate compensating reductions in other spending programs. The Congress, therefore, has much more flexibility to deal with BIF's financing needs without causing unwanted compensating short-term budgetary

changes. Of course, any further burden on the budget must eventually be paid for.

Any plan for meeting BIF's funding needs depends greatly on how profitable banks are. The financial condition of BIF will mirror the condition of the industry that it insures, and the resources available from the industry will depend on its financial health. While CBO's long-run assessment is optimistic on this score, small changes in circumstances--including the state of the overall economy and regional conditions--can have large impacts on the solvency of the banks and of BIF. Moreover, any new legislation dealing with bank powers could have significant long-term effects. Other factors, such as regulatory practices, are also of key importance. Improving rules and methods for bank closure can help lessen the overall costs of bank failures. One lesson of the thrift crisis was that delay in closing failed thrifts appeared to add greatly to the cost of resolving them. Making sure that failed banks are resolved in a timely fashion is critical to keeping costs down.

BIF's immediate liquidity needs cannot be remedied by long-term regulatory reforms. To avoid delaying necessary bank closures because of a cash shortage, the FDIC must have the resources to undertake those closures. Expanding BIF's ability to borrow from the Treasury or FFB would seem to solve the immediate liquidity problem.

Assuring that the FDIC can continue to resolve failed banks in the immediate future without delay would leave sufficient time available to determine the best way to recapitalize BIF over the long run, should a more permanent funding source be needed. That decision could then be made in conjunction with a consideration of deposit insurance reform and other bank regulatory reforms that appear on the Committee's long-term agenda.

The CHAIRMAN. Well, thank you. We want and we will need your help.

Let me call on Senator Sarbanes for any initial comment that he might have, and then Senator Bryan.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Mr. Chairman, I'll be very brief. I, first of all, want to commend you again for holding this hearing, for moving so quickly at the beginning of this Congress to address this important issue.

I'm concerned that with each succeeding witness and each succeeding testimony, the situation that we confront worsens noticeably. I think this is the more pessimistic of the outlooks that we have thus far received.

And, of course, as I understand the conclusions, and I'll address that in my question period, it's really recommended that we go to the public Treasury to borrow the money in order to meet the problem, over the short run at least.

That's a significant departure from what I understood Mr. Seidman to be saying when he was here, which seemed to be that it could be done within the industry itself. Of course, that's a rubicon to be crossed, if, in fact, it's, as Mr. Reischauer says today, a case that it cannot be done except to increase the claim on the public money, or at least the public exposure.

I assume this is but one in a series of these hearings that we're going to be having in order to explore exactly what can be done but, obviously, it's increasingly becoming a crisis situation.

I look forward to the question and answer session.

Thank you.

The CHAIRMAN. Thank you, Senator Sarbanes.

Senator Bryan.

Senator BRYAN. Mr. Chairman, thank you very much. I'll defer any opening statement and look forward to my chance to visit with Mr. Reischauer during the question period.

The CHAIRMAN. Very good.

Let me start out this way. You've given us very interesting testimony today. And you point out that, as you look at the banks across the country, about 11,000 of the banks seem to be doing pretty well. And you've got 2,000 or so that aren't doing as well. And then, in that group, you have some that are really in tough shape.

And I take it, because of the split on the percentage of assets, too, that the banks that are in trouble—not in all cases, but in a number of cases—tend to be larger banks, and big banks.

Is that a fair statement?

Mr. REISCHAUER. Well, the banks that are in real trouble actually tend to be relatively small ones. There's an intermediate group of banks that are troubled and that tend to be large banks. And, of course, the discouraging fact of the current situation is that few of the largest banks are among the healthiest banks.

The CHAIRMAN. Now, the Bank of New England, which just failed, would be thought of by you, I assume, as a large bank?

Mr. REISCHAUER. Correct.

The CHAIRMAN. All right. Now, when you look at the profile, as these reserves are drawn down by the bank failures that we're seeing, are you familiar enough with the profiles behind the banks that are failing and are putting the claim on the Insurance Fund to give us some sense as to what causes some of these banks to fail and others to sail along quite well?

Is there any kind of a qualitative analysis that you've been able to do that goes into the problem to see the profile of the banks that are failing? Are they in some regions of the country? Did they tend to get into certain types of activities?

Do you have a sense as to where the problem is coming from and why some banks are failing and others are not?

Mr. REISCHAUER. We haven't done an analysis of that sort. It certainly would be an interesting one to do. It would depend on data that I don't think are available at present. The banks that are failing are obviously the most weakly capitalized banks and those that tended to be heavily into assets in the real estate area.

The CHAIRMAN. We're going to have to get that, and maybe you can help us. The issues here are not just strengthening and shoring up the Fund, and, hopefully, avoiding another taxpayer requirement, but also making some major changes in the banking system. We may hear from the President tonight in the State of the Union Message something along those lines.

Before we can get very far down that track, we have to understand where these losses are coming from. What's the profile of failure that we're seeing?

We've got to have some kind of a qualitative analysis, because, as you point out, we've got 11,000 banks in the country that have capital ratios above 6 percent that are chugging along pretty well and doing pretty well.

So, I'm going to ask you, if you can, to devote some effort to see if you can figure it out. I might just give you as a reference point, in the savings and loan situation—and Senator Domenici will find this interesting as a new member of the committee—70 percent of the losses that we've incurred in the savings and loan system have come from State-chartered institutions in just two States—Texas and California.

So, you find a very odd profile as to where the bulk of that problem has come from. And I would be interested in having you do some analytical work in this area for us.

Now, you anticipate that, even with increases in the insurance premiums that are paid by banks, you see the Fund running out of money, according to your testimony, early in fiscal year 1992.

Is that correct?

Mr. REISCHAUER. Correct.

The CHAIRMAN. Now, what will the shortfall be at that time, as best you can estimate it?

Mr. REISCHAUER. The situation can be summarized by looking at table 1 in my prepared testimony, which suggests that by the end of fiscal year 1991, which would be September 30, 1991, the Fund balance would be down to $1.4 billion and headed south.

The CHAIRMAN. Right.

Mr. REISCHAUER. One year later, it would be down to a negative $2.8 billion. So, that suggests that sometime early in fiscal year 1992, the Fund would go under.

The CHAIRMAN. So that could actually happen at the tail end of this calendar year then.

Is that correct?

Mr. REISCHAUER. Correct.

BANK INSURANCE FUND IN DEFAULT BY END OF YEAR

The CHAIRMAN. All right. So, by the end of this calendar year, we could actually find our Insurance Fund in default, and out of money.

And I'm struck also that you say it's not just the account balances but liquidity as well. They're not going to have the cash in hand to handle things.

Now, I think we've got to avoid that consequence by one means or another.

Now, do I understand that you assume that there will be an increase in insurance premiums during this calendar year that kick up the income into the Insurance Fund?

Mr. REISCHAUER. Correct. We assumed that the premiums would rise to 23 cents on July 1 of the current year, and then would rise again at the beginning of calendar year 1992.

The CHAIRMAN. So your assumption that the Fund, in effect, will be broke probably by the end of this year comes despite an increase in the premiums that banks pay that will bring additional money in. But even that won't be enough.

Is that correct?

Mr. REISCHAUER. Correct.

The CHAIRMAN. That's what you're telling us.

All right. My time is up.

Senator Heinz.

EARLY INTERVENTION

Senator HEINZ. Mr. Chairman, thank you.

One of the prescriptions for avoiding losses to the Bank Insurance Fund and, indeed, it's been advocated as a major element of deposit insurance reform, is early intervention.

Unhappily, we have in the case of the Bank of New England a case where nobody intervened early enough. In fact, this was a case where apparently everybody in the industry knew that there were profound problems with the Bank of New England—not a year ago, when the Comptroller forced a new President on the bank—but 3 years ago.

Second, by the time the bank was, in fact, closed, it wasn't closed when its net worth reached zero. It was not closed until it had estimated losses of $2-$3 billion. We're not sure exactly how large the losses are going to be.

But, assuming that we, in fact, have regulators who are competent and capable of actually intervening early, so that when a bank is in trouble you stem the losses and, close the bank before the net worth is zero, could that have a major impact on the kinds of loss estimates that you are seeing for the Bank Insurance Fund?

Mr. REISCHAUER. If we had been doing it over the last several years, you would be correct, that would make the outlook a good deal brighter and——

Senator HEINZ. What would happen if the regulators really started intervening early and they moved in on all the problem banks tomorrow? How much would that change your assumptions about the losses?

Mr. REISCHAUER. We haven't done an estimate like that. The estimates that I presented to you are largely based on historical patterns, the patterns over the last 2 or 3 years. If there were a substantial change in the behavior of the regulators to start examining more carefully those banks that fall below certain capital levels and then to intervene and close these banks as they approached insolvency, it would make a considerable difference. And we could look into that for the record for you.

Senator HEINZ. So that, if our regulators really implemented that strategy today, it could save us a lot of money?

Mr. REISCHAUER. I think that the regulators are probably more on top of this now than they were 2 or 3 years ago, and that there is an effort being made in this direction already.

Senator HEINZ. But it's my personal opinion, and I don't know what yours is on it, but I think the Bank of New England shows that the regulators aren't on top of it.

How can regulators who claim to be on top of things and preaching early intervention not intervene after the horse is out of the barn? And then with a big fanfare, they slam the door and say, "See what a great job I'm doing?"

The reason the Bank of New England sticks in my craw so much is that, when the Bank of New England was created with the merger of the Connecticut Bank and Trust Co., the man who came over from Connecticut Bank and Trust took charge of that operation, did something very interesting:

He eliminated what's known in most banks as the credit department.

You know, in most banks there's a loan department and a credit department. The loan department initiates the loan; the credit department says: That guy's credit is no good, or it is good.

And he said, "We don't need to do that."

And everybody in the banking industry knew, and this is even more than 3 years ago, that the Bank of New England was heading for the edge of the pond and some pretty thin ice.

Let me ask you this. Is there any——

Mr. REISCHAUER. I'm not going to defend the behavior of the regulators in this situation, but I would like to point out that, in areas like New England, the circumstances change very rapidly. The economy in New England entered into a free fall, and the process of examining the condition of a bank isn't something that's done overnight. It takes months. And so it's difficult to stay ahead of the ball, so to speak, in this kind of situation.

Senator HEINZ. I'll be happy to debate that with you on some other occasion and go through the examination process and what in my mind is the basic incompetence of the people who are doing that. But, because I would submit that New England has been over-

built for office space for a lot more than 12 or 24 months, along with a lot of other areas of the country.

And when you are looking at a bank's loan portfolio, you should question why cap rates are being lowered, values are being written up, in spite of the fact that absorption is not taking place, as they say in the industry and, in fact, you've got a big overhang of office space or shopping center square footage, and so forth.

BARRIERS TO INTERVENTION

My last question—my time has expired—is this:

Is there any barrier to any of the regulators? The Fed, the FDIC, the Comptroller, the Office of Thrift Supervision, OTS—intervening early?

Mr. REISCHAUER. Not that I'm aware of, but let me just check on it. [Pause.]

I think they do have the powers to intervene, but because of the legal complexities that might arise from early intervention, they haven't exercised those powers as much as might have been——

Senator HEINZ. Legal complexities. What legal complexities? Either they have the authority or not.

Mr. REISCHAUER. They have the authority, but that authority can be challenged—there could be a suit on whether the circumstances justify closure of the institution.

Senator HEINZ. Mr. Chairman, I want to make just a brief comment on that because if I hear that—I don't mind hearing it from Bob Reischauer, but I hear that from a regulator, I don't know what I'm going to do but it won't be pleasant for me or them because the last I heard, a Federal bank charter is not something that you were entitled to by right. It is a grant of public trust. It carries with it tremendous exposure to the taxpayer in the form of deposit insurance, in the form of access to the Fed discount window, in the form of lots of other life-support mechanisms and earning support mechanisms.

It seems to me that all a regulator has to do is say:

Look, you have responsibilities under this bank charter that in our judgment you are not meeting. Your capital, in our judgment, is not what you say it is. It's not 6 percent. It's 3 percent or 2 percent and headed down. And we will give you a choice. You can either (a) go out and raise X-hundred million dollars worth of capital, because that's what we think you need to be solvent—you're under the capital requirements; or (b) you can sell your bank to somebody else, or you let us take it over. If you can't sell it, that's proof that the bank isn't worth anything, regardless of what you say it is. And so we have every justification for doing so.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Heinz. I think there's an important message for an audience wider than just the one that's tuned in at the moment.

I'm going to yield to Senator Shelby. Before I do, I want to say one thing because with all of the live television going out of here today, it is important for people across the country to understand that, while the Insurance Fund is at a very low level and may very well be exhausted by the end of the year, people with savings in

federally insured institutions can be confident that their money is protected up to the insurance limit, which is $100,000 per institution.

And so we should not leave any sense that that protection is not absolutely solid and in place. It is. And people can be confident that that pledge is solid and that they need not worry about the insurance system being in trouble. It does not mean that their deposits are endangered. They are not—in federally insured institutions.

By the same token, if somebody's not in a federally insured institution, they'd better understand that as well. They'd better understand exactly what kind of an institution they're doing business with.

Senator Shelby.

Senator SHELBY. Mr. Chairman, I have an opening statement that I'd like to be made part of the record.

The CHAIRMAN. We'll make it part of the record.

Senator SHELBY. I would have been here earlier, but we had an earlier meeting in the Energy Committee, and I'll await my time for questions.

STATEMENT BY SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I commend you for scheduling this morning's hearing and I appreciate our witness from CBO taking the time to be here.

I am particularly pleased that we will have the opportunity to hear from an unbiased source on the true condition of the Bank Insurance Fund and its anticipated condition after the hits that it is likely to receive. While we take no pleasure in hearing of heavy losses, we would greatly prefer to know now what the worst case scenario is, rather than wait until that scenario becomes a reality.

In my conversations with others on the current pressing need to reauthorize funding for the RTC, I am struck by how often it is acknowledged that if the administration, and Congress, had addressed the savings and loan crisis in a timely way, we would have spent only a small percentage of that which we have already spent and will spend.

The Federal Government failed the taxpayers of this country with the savings and loan crisis. Taxpayers will spend tens of billions that would not have been necessary if the administration and the Congress had confronted the problems in the S&L industry head on.

We cannot make that same mistake again, we must fulfill our obligation to the taxpayers and ensure that we maintain a safe, strong banking industry without asking the depositors to bail out bad banks.

For this reason, we need your honest and accurate estimate of what problems do exist and the magnitude of their cost. This committee intends to enact comprehensive deposit insurance reform to prevent problems in the future, but we must deal with the present problems immediately. As the savings and loan crisis demonstrated, timeliness is essential.

Thank you, Mr. Chairman.

The CHAIRMAN. Very good.
Senator Sasser, the chairman of the Budget Committee.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Well, thank you, Mr. Chairman. I would just like to make one comment at the outset, if I may. I'd like to remind our colleagues here today that last year's Budget Act did give the FDIC unlimited authority to increase bank insurance premiums to meet the losses in the Insurance Fund.

Now, Chairman Seidman indicated about 2 months ago that the FDIC could use this authority to resolve the problem in the Fund.

Now, it goes without saying, and I'm sure the chairman and my colleagues agree with me that we want to do everything possible to avoid turning the recapitalization of the Bank Insurance Fund into another massive taxpayer expenditure.

I think the condition of the banking industry and the FDIC today is in good part a result of the go-go investment climate of the 1980's. Our banking system is critical to our domestic economy and, unfortunately, I think it's now in disarray as a result of the excesses of the 1980's.

Now, in my view, the response of the regulators has not been evenhanded. For instance, they've created a situation where, if you're a million dollar depositor, or if you are a foreign depositor in a large enough bank, your money's as good as gold.

But, if you're banking at a small or medium-sized bank across this country, you'd better watch out.

I think this situation is inequitable and I think it's unstable and it makes a taxpayer infusion all the more likely.

Big banks do not pay insurance premiums on foreign deposits, while small banks and medium-sized banks pay premiums on all of their deposits because they don't have any large foreign deposits.

Since the big banks are not paying insurance on these large foreign deposits, the FDIC has less money to deal with its financial problems, which, ironically, reside in the very same large banks that don't pay premiums on these large foreign deposits.

So, Mr. Chairman, I know you are aware of this problem and are concerned about it, and I look forward to working with you and the other members of the committee on legislation that I plan to introduce shortly which address this issue.

Just this question for our able Director of the Congressional Budget Office: Dr. Reischauer, the presentation that you've made here today—and correct me if I'm wrong—assumes that the economy's in for a mild recession.

Isn't that correct?

Mr. REISCHAUER. Correct.

Senator SASSER. Now, the CBO has predicted this will be a mild recession.

But, what if it's not a mild recession? I hope this is not the case. But, if we experience a downturn that is more severe than the one you're currently projecting, what are these numbers going to look like?

And if we get into a severe downturn rather than a mild recession with a fairly quick recovery, what's going to be the banking

industry's ability to make a financial contribution to recapitalize the Bank Insurance Fund?

Mr. REISCHAUER. The answer to that question was contained in the simulations that I reported in my prepared testimony, which indicated that a severe recession might push up the cost by anywhere between $6 billion and $7 billion a year, most of it falling over the next couple of years. Substantially larger losses also would clearly make it much more difficult for the banking industry to be the source of all of the recapitalization that was needed.

The CHAIRMAN. If I may, is that satisfactory for now, so we can——

Senator SASSER. Yes.

The CHAIRMAN. Very good.

Senator Sanford has come in. Did you have an opening comment before we go to Senator Wirth?

Senator SANFORD. Well, I had about a half an hour of comments, but I believe I'll just put my statement in the record.

The CHAIRMAN. Well, if it's a half an hour, maybe we ought to take it.

Senator SASSER. Well, could we just hear 10 minutes of it, Mr. Chairman? [Laughter.]

Senator SANFORD. I'll put my remarks in the record. I also have a number of questions for Mr. Reischauer.

The CHAIRMAN. We'll make the statement a part of the record.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you, Mr. Chairman, and I would like to thank CBO Director Reischauer and the staff at the Congressional Budget Office for the fine work they have done in preparing the testimony for this morning's hearing.

This morning we must again turn our attention to a very difficult subject—the financial condition of the Bank Insurance Fund. Obviously, this issue takes on a heightened sense of drama in the wake of the failure of the Bank of New England, where over $1 billion in deposits was withdrawn in a day, and in light of testimony before the House Banking Committee where a team of economists stated unequivocally that the Bank Insurance Fund is insolvent.

I think in beginning of this hearing, it would be well to remind the public that deposits of up to $100,000 are and will be fully protected. Any discussion about the condition of the Fund need not instill panic among the millions of Americans who have placed their savings in banks, thrifts and credit unions. The Federal Government has pledged to stand by its insurance guarantees. The painful votes we cast to dedicate $50 billion to the Insurance Fund of Savings & Loans should leave no doubt in anyone's mind that deposits up to the insurance limit are safe.

With that being said, we must be willing to look honestly at the condition of the Bank Insurance Fund and the difficulties that lie ahead for the banking industry. I am particularly troubled by the poor financial condition of the Fund during our current recession. I am quite concerned that we may be entering a difficult spiral, in which banks and thrifts are reluctant or unable to lend money, due to capital and other constraints, and that this inability to lend

leads to further contractions in the economy, which in turn causes business to contract, which then places much greater strain on the banking system and the FDIC.

We may very well be entering a period in which strong action is necessary to break this spiral. I am working on potential legislation to create an Emergency Bank Investment Corporation. This Corporation would be a Government-sponsored corporation which could make equity investments in marginally capitalized banks in order to bring greater stability and capital to our financial system. Such efforts could go a long way toward preventing unmanageable numbers of bank failures. I must note, however, that any efforts to bring greater capital to the banking system will only work if in the long run we are able in enact fundamental reforms to our deposit insurance system that permit early intervention into failing institutions and which remove some of the barriers to consolidation and competitiveness.

It is my hope that proposals such as this one and many others are considered as we look at ways to both shore up the Bank Insurance Fund and to do what we can to stave off unnecessary bank failures. I hope we will keep both goals in mind as look at future legislation and that we will move in an expeditious fashion. If we learned nothing else from the S&L crisis, I hope we have learned that problems in the financial system will only become much worse if we wait too long to address them.

I look forward to the testimony of the CBO this morning and to exploring ways to strengthen the Bank Insurance Fund.

The CHAIRMAN. Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you, Mr. Chairman.

Obviously, as we examine this problem, we're doing so in the shadow of the S&L disaster. And we want to make sure, one, we learn from what didn't happen in the S&L disaster so we don't repeat mistakes that might have occurred then.

And, second, I think, Mr. Chairman, we certainly want to be in a situation where we hope to limit the exposure of the taxpayer. And it's behind that that is the thrust of my questions.

First, it seems to me that one of the things that we learned during the S&L disaster was that, in order to conserve funds, because they didn't have the funds, the FSLIC did not intervene early enough.

And the question is, I have to you:

Do you have any evidence that this is also occurring at the FDIC? We've seen the Bank Insurance Fund drop very precipitously. The numbers up here in these charts are indicative in some way and, in fact, it's significantly worse than that, because that $9 billion in the Fund has gone down, according to Mr. Seidman, to four and presumably could drop below that very significantly.

Do we have any evidence that because of that problem and the need to conserve funds, the FDIC has not intervened as early as maybe they should have to avoid the kinds of problems we had from the S&L crisis?

Mr. REISCHAUER. We have no explicit evidence of that. There have been suggestions that the delay in dealing with the Bank of New England was associated with those kinds of considerations.

What my testimony suggested is that this could become a problem during this fiscal year because the Fund will have insufficient resources to deal with a large bank failure and limits on its borrowing authority. And that's why I suggested that it would probably be prudent to eliminate those limitations on borrowing authority so that the same kind of mistakes that were made during the 1980's with respect to the savings and loan situation did not reoccur.

Senator WIRTH. So we don't have evidence that that has occurred so far, but in order to avoid the temptation that the FDIC might have to conserve cash, we should, therefore, move rapidly to augment the Fund?

That's the general policy direction that you all are recommending that we take. So then the question is—is that right?

Mr. REISCHAUER. We don't make recommendations, but that would be a prudent conclusion——

Senator WIRTH. A good budget analyst would say that that might be a prudent course to pursue.

Mr. REISCHAUER. Correct.

Senator WIRTH. Then, going to the second part, let's avoid the problem that we had in the S&L catastrophe.

The second concern that many of us have is that can we do this without an enormous exposure of taxpayer funds?

And as I understand your testimony, a prudent budget analyst might suggest that, in order to do it without taxpayer funds, you can do two things:

One, increase the premium over a 3 year period of time to 30 cents.

And, second, to, in the interim, allow the FDIC to borrow from the Treasury.

That might be a prudent approach to take? Is that what you suggested?

Mr. REISCHAUER. That's correct. That's what I would suggest.

I would also like to note that, in a sense, I think some of the numbers that I presented have been either misinterpreted or mischaracterized. We are not saying that this is a black hole of the sort that developed during the 1980's in the S&L industry. What we're saying is that, if one looks at this problem over 6 or 7 year period and higher premiums are assessed of the sort that we have assumed in our baseline, the situation will stabilize. The Bank Insurance Fund, looked at over this longer perspective, is solvent despite the fact that, in the short run, there will be severe liquidity problems.

Now, this assumes that we have a mild recession and a steady recovery after that. But, some of the numbers that have been presented in the media, particularly those attributed to the administration, in fact are a little more pessimistic than CBO's numbers. We are not presenting a set of baseline numbers that are the gloomiest ones in town.

Senator WIRTH. OK. I thank you.

If we then say what we want to do is beef up the Fund so that we don't tempt the FDIC to a nonintervention strategy, and that we want to try to do it without taxpayer funds, that begs then two questions.

One, does the administration have the authority now to do the two things that you would suggest? To increase the premium and to allow the FDIC to borrow from the Treasury?

Can they do that now without authority from Congress?

HOW MUCH AUTHORITY DOES THE ADMINISTRATION HAVE?

Mr. REISCHAUER. The administration has the authority to increase premiums. The Omnibus Budget Reconciliation Act that was passed at the end of the last session gave the FDIC the authority to raise premiums twice a year to unlimited levels.

But, the FDIC does not have unlimited authority to borrow. The borrowing is limited to a $5 billion amount from the Treasury. And the borrowing from the FFB is limited by the restriction that the Fund has to be solvent and the net worth of the Fund can't fall below 10 percent of the value of its assets. And we expect that to be the constraining factor here.

Senator WIRTH. How much more authority would a prudent budget analyst suggest should be given to the FDIC?

Mr. REISCHAUER. Probably, a minimum of $5 billion to $10 billion. But, if you didn't want to revisit this issue periodically, you might consider amounts slightly larger than that.

Senator WIRTH. Well, then that begs the second question.

What would occasion us having to revisit this issue? I mean, how severe, how much more severe than you're projecting would the recession have to be so that the package of recommendations that you make would not be adequate and we would have to move into the use of taxpayer funds to bail out failing banks?

Mr. REISCHAUER. Over and above this added borrowing authority?

Senator WIRTH. Over and above. Say, if they have the authority to raise the premium and the borrowing authority, you know, how much more severe would the recession have to be that that package would not be adequate?

Mr. REISCHAUER. Probably, deterioration of the balance sheets of banks of the sort that occurred in Texas—a rather severe downturn. We're predicting right now a recession that has a drop of real GNP, peak to trough, of a little over 1 percent. The average postwar recession involves a drop of about 2.6 percentage points. You'd probably have to get up around the average or above-average recession for that to occur. And the recession would probably have to be nationwide in scope. Remember, these sharp downturns that we've had have been confined to regions of the country. They represent the confluence of various factors—a weakening overall economy combined with a shock to a region such as a fall in oil prices.

Senator WIRTH. I know my time has expired, Mr. Chairman, but what we're just hearing is that the package being recommended here is adequate for a mild recession. But that, if we have an average recession, then this package is not adequate and we're going to have——

Mr. REISCHAUER. This package would probably be adequate unless the recession is more severe than average. I was very vague about what this package was. I said a minimum $5 billion to $10 billion additional borrowing, and then slightly more to be prudent.

Senator WIRTH. I think we want to examine this further to find out how, you know, if we go further to what I thought you said earlier, an average recession, we're going to have some very significant problems in the Fund.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Wirth.

Senator Bryan.

Senator BRYAN. Thank you very much.

Let me follow on with Senator Wirth's line of questioning. Assuming for the sake of argument that the recession becomes deeper and more protracted than a mild recession or an average recession, will this formula that you have recommended to us, namely, the combination of increased insurance premiums plus the borrowing from the Treasury, will that be sufficient in terms of a methodology to address the problem? Cranking in whatever numbers may have to be borrowed from the Treasury?

Mr. REISCHAUER. I think the primary question here is over what length of time does one want to answer this question. We have a timeframe here running through 1996. And we suggested that the increase in premiums would be sufficient to pay off the borrowing with interest over this period.

Clearly, if we extend the period 5 more years, the Fund begins to build up and one could look at it, to try to answer your question, over a decade-long period. One could also raise the premium level above the 30 percent maximum that we have assumed in our estimates. This is a form of creeping recapitalization, so to speak, but the premium could go up 3 to 5 cents a year for a number of years.

ABILITY OF THE INDUSTRY TO ABSORB THE INCREASE IN PREMIUMS

Senator BRYAN. In your opinion, based upon the condition of the industry today or as you may foresee it in the out-year if this recession does become a longer recession, can the industry absorb the additional increase in premium outlay?

Mr. REISCHAUER. I think that, over a decade-long period, the answer would be yes. Fundamentally, the industry is healthy and can absorb these costs. The real issue here is financing this recapitalization and spreading out the burden that's placed on the industry over a number of years.

Senator BRYAN. One of the concerns that I have, and I think it's a concern shared by all that served on the committee, is that we have just gone through the savings and loan disaster in which the American taxpayer is ultimately the indemnitor for a series of failures which occurred during the previous decade. None of us want to revisit that unhappy experience with the banking industry.

And there are some lessons, it seems to me, that we might profit from based upon some of the mistakes made in the previous decade.

Let me ask you specifically your own thoughts with respect to this too big to fail concept. Senator Sasser touched upon that in his line of questioning.

It does strike me in terms of fairness and equity in talking with the public about sound public policy that, you know, the institution is so large, even though foreign deposits do not pay insurance premiums, that they, in effect, are covered.

Should we change that? And if we should, wouldn't that reduce the exposure on the Fund and thereby at least put further into the background as a contingency that the taxpayer might ultimately have to bail out the industry?

Mr. REISCHAUER. I think we're de facto providing insurance coverage to foreign deposits. And as a general principle, those deposits that are covered by insurance should contribute to the cost of the insurance program.

Senator BRYAN. Do I understand—I don't want to put words in your mouth, but I think you're indicating that as a matter of principle you feel that those who benefit from the provision ought to pay the corresponding cost of the coverage? That's your position.

And I believe you're saying that the foreign deposits ought to pay insurance premiums?

Mr. REISCHAUER. That's a correct reading of my remarks.

MULTIPLE ACCOUNTS

Senator BRYAN. All right. I appreciate that.

We had some testimony before this committee last fall in which representatives of the European and the Japanese banking community came and testified before us. And they indicated to us, if I recall their testimony, that, although their systems and their approach differ, they do, at least in concept, limit the exposure to a single account, as I understood it.

That's not our practice now. And those of us who have tried to read a little bit of the background of this, historically, this concept of the insured account was advanced to restore public confidence in the aftermath of the devastation of the Great Depression.

It strikes me if that's it's philosophical genesis, it's pretty hard to justify the present system, which involves the multiple deposits which are now covered, thereby expanding the liability of the Fund and ultimately bringing the American taxpayer that much closer to the edge of perhaps being required to respond if the situation goes badly.

My question to you is:

Do you think that we ought to try to limit the coverage to a one-account system? And, if so, can that from an accounting point of view be managed? Apparently, it's done in Europe and Japan, if I understood their testimony.

And then the follow-on question to that, it's been argued by some in the smaller banks, that that really is so inherently unfair to them that it would cause a flight of capital from those smaller banks, which are essentially more solvent than some of the larger banks.

Could you address that series of questions for me?

Mr. REISCHAUER. I think, overall, it would be difficult to implement, though not impossible. But I also have the feeling that limitations of this sort are likely to be circumvented by the sophisticated and not by the unsophisticated. And it's really the unsophisticated depositor that the political system responds to, that we as a nation care about.

And we shouldn't devote a tremendous amount of our energies to devising strictures of this sort when there's some larger, more fundamental reforms that I think could take place. I don't think changing the limit or enforcing the $100,000 limit is going to make a huge difference with respect to the Bank Insurance Fund losses.

Senator BRYAN. I want to be very clear that my question was understood, Mr. Chairman. I know my time is up.

I wasn't suggesting that the $100,000 coverage be reduced to some lesser figure of $80,000, $50,000 or something like that.

Mr. REISCHAUER. Correct.

Senator BRYAN. I was talking about the multiple deposits which do, it seems to me, add to the exposure of the Fund. And some would argue that the philosophical underpinning of the insured deposit system was not, in effect, to finance the more sophisticated investor, who, in theory, as a broad range of options which he or she might want to consider in terms of that investment program that the individual might want to pursue, but that we ought to kind of try to narrow the focus.

And I'm gathering you're saying that, as a practical matter, you don't think that that probably could be done? Again, I don't want to put words in your mouth.

Mr. REISCHAUER. I think it could be done, but it would be difficult. I think also you might want to consider, if we're explicitly insuring certain deposits and not other deposits, whether the deposits that are not insured should also pay the premiums. This is going back to my answer to the first question you asked.

Senator BRYAN. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Very good.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

We've beat this around the committee and around the Hill, I guess. How did we get to this disastrous turn in the road? Now, who knows what the projected bank bailout is going to cost? With all due respect to you, and I have a lot of respect for you personally and the agency you represent you certainly don't know. There are only projections here.

Some of these projections seem mighty rosy to me. The testimony before the Banking Committee seems to low-ball the figures and paint a rosy picture, at least rosier than it should be. Not just your testimony but that of others that have come here. I'm afraid we've been here before.

We sat here and heard the S&L story. This is similar in some ways. Some people say, oh, no, the bank situation is nowhere near that. I submit to you it could be much larger—much, much larger. We pray not.

But, what have we learned? What have we learned here?

I'll tell you what. I'm not sure that the regulators have learned a lot. We keep going down this track. But I'll tell you something that taxpayers have learned in the last couple of years:

They don't want to bail out the banks. They didn't want to bail out the savings and loans. And if you don't believe this, just go out in America and ask them. Just see. They don't want to shoulder that burden.

And then, just the other day, you know, there's testimony here wanting a blank check for the savings and loan. Open-ended funding. The administration came before this committee a year or so ago, year and a half ago—the chairman knows this well, a lot of you do—said "$50 billion was going to bail it out. It was going to take care of everything."

Why, God knows, we know where we're going now. And this bothers me. This Senator is concerned about this, as other colleagues here are.

Where are we going?

I'd like to follow-up with a question.

What role does size play in the rate of bank failure?

You indicated in your testimony that the percentage rate of nonperforming assets is higher in large banks, those with more than $10 billion in assets.

Is it fair—would it be fair to make a statement that smaller banks, assuming adequate capital, are safer banks than large banks?

It's been said that the business of banking is local, meaning that the better you know your market, the better you know your customer, the more successful generally you will be.

In my State of Alabama, we don't have banks with more than $10 billion in assets in my State. Our largest holding company has about $9 billion in assets.

In addition to the holding companies in my State of 4 million people we have about 180 small banks. The banking system, according to the regulators in my State, is in good shape. We haven't had a lot of boom. We hadn't had any busts.

Do you have any comment on this? Is it indicative that because the banks know their markets well that they don't make these disastrous loans? Did these big banks grow too big to maintain their familiarity with their market, with the people they were making these loans to?

Mr. REISCHAUER. I have some data here on the probability of failure coming out of our models. And, of course, these aren't facts but projections. What they suggest is that, of the weakly capitalized banks——

Senator SHELBY. We're talking about stronger capitalized banks.

Mr. REISCHAUER. Well, I'm going to talk about them, too.

Senator SHELBY. OK. OK. Go ahead.

Mr. REISCHAUER. But I'm just starting with the basket cases.

Senator SHELBY. Starting with the worst.

Mr. REISCHAUER. Yes, starting with the basket cases—those with equity to asset ratios of below 1.5 percent—the failure rate is fairly constant by size. There's not a large discrepancy. If we go to the well-capitalized institutions—the banks in group 1 in table 2 of my prepared testimony——

Senator SHELBY. In your testimony.

Mr. REISCHAUER. Yes, in my prepared testimony. The failure rates of the smaller institutions are a bit above those of the largest institutions.

Senator SHELBY. But, are these well-capitalized smaller institutions?

Mr. REISCHAUER. Yes. All of the institutions in group 1 have assets of more than 6 percent. And for the largest banks, the probability of failure is about 1.5 percent; for the smallest banks by asset holdings, about 2.3 percent. And that's true for the second group—the banks that had between 3 percent and 6 percent capital.

Senator SHELBY. When a big bank goes under——

Mr. REISCHAUER. When it goes under, you hear the noise.

Senator SHELBY. It's like an aircraft carrier running into a small boat, isn't it, when it runs into that Fund. And there's nothing left. Is that right?

Mr. REISCHAUER. That's correct. But, once again, if you look at table 2 in my prepared statement, you can see that among the highly capitalized banks, the Fund losses associated with the largest banks are $2.8 billion, while for the smallest banks, they were $4.6 billion. That's among the well capitalized banks.

In the second group, which comprises the slightly less well capitalized banks and which has significantly more large banks failing, the reverse is true. There's a very small hit from the small banks—$1.4 billion over the 1990–93 period and $11.3 billion from the largest banks—which is proof of your point.

Senator SHELBY. In other words, the larger they are, the general statement would be, the bigger the failure? I mean, the numbers anyway.

Mr. REISCHAUER. But, once again I go back to the methodology that we have used in making our estimates. Built into that methodology, of course, is the past behavior of regulators, because what we're doing is looking at past experience and projecting the future based on that experience. And to the extent that regulators have followed a "too big to fail" policy, therefore, these numbers are skewed in the direction of minimizing the impact of——

Senator SHELBY. "Too big to fail" has aided and abetted the problem we have, has it not?

Mr. REISCHAUER. Yes, but it's also minimized the numbers that I've just given you, or reduced the size of the numbers I've just given you for large banks.

Senator SHELBY. My time's expired.

The CHAIRMAN. Very good.

Senator Sanford.

Senator SANFORD. I want to thank you for a very fine statement, very well-prepared and it certainly gives us some fundamental information.

The thing that bothers me in following up on what Senator Wirth and Senator Bryan had to say is that it appears that we are trying to do the same thing we tried to do for the S&L industry. I remember debating here whether we should have a $15 billion or a $7.5 billion increase in the reserves, which turned out to be totally irrelevant.

In any event, we are trying to make more funds available to the FDIC so they can move more quickly in closing a bank and paying off the depositors. We almost accept it as inevitable that these banks are going to fail and we want to be braced to take care of them adequately without going to taxpayers' money.

INCREASED PREMIUMS AND BANK FAILURES

Now I don't want to agree with that concept if we can find a better way. I think adding premiums does two things. And let me just say if you disagree, disagree. I don't want to be making a statement as much as seeking your advice. But it seems to me that adding to premiums and upping premiums does two things.

First, by assuming that we're going to have all these failures, we, in effect, have adopted the attitude that there's nothing we can do about them.

But, second, it may very well diminish the capital of marginal banks to a degree that will cause more failures.

What about that proposition?

Mr. REISCHAUER. That's true, and that is built into our estimates. We have a slight increase in failures associated with the fact that we have raised premiums.

Senator SANFORD. Now there have been some proposals that perhaps if we paid additional assessments, maybe as distinguished from premiums, but in effect the same money, into a pool that could be used for increasing the capitalization in other banks, we might stop some of the bank failures.

You are familiar with that proposal. What do you think of it?

Mr. REISCHAUER. I think you want to look at the banking industry and ask yourself in what direction is it headed over the long run. We have seen the number of banks decline by about 2,000 over the 1980's. There's every reason to believe that probably too much in the way of resources resides in the banking sector right now, and that the number of banks will probably continue to shrink.

What you want to do is not try and fight the inevitable. And the question here with respect to any of the schemes that would recapitalize banks, weak banks that otherwise would go out of business, is: Are you really doing the industry, the efficiency of the economy, any good in the long run? And given that I think what we have——

Senator SANFORD. We need more mergers and acquisitions and consolidation of capital.

Mr. REISCHAUER. Consolidation is what we've seen in the past decade and what one would project for the future as well.

Senator SANFORD. I have been working with an idea that I'm going to circulate to my colleagues on the Banking Committee this week that would try to get at the flaws that come out of what we've talked about so far.

Capital is spread too thinly. No doubt about it. Capital is not available, and a reshuffling of capital with additional fees or premiums doesn't really add any new capital to the banking system.

There's no question in my mind that we need the kind of reforms that increase consolidation, increase competitiveness and, ultimately, increase capital.

Now I reached back in history for an idea. The worst thing about that idea was that it didn't sunset at the proper time. We would have this one sunset. The Reconstruction Finance Corporation concept, which I think can be worked with a fund for investment in banks and bank stock in the same way that we did for Chrysler. It would shore up banks, encourage private investors to buy stock and put considerable amount of new money into the system without any taxpayer expense.

Now, shouldn't we be working for something like that?

Mr. REISCHAUER. That once again gets to the issue of whether you are trying to keep in existence institutions that are——

Senator SANFORD. No, no, I think just the opposite no one would invest in a bank that ought to consolidate or ought to be merged. Thus, banks would have an additional incentive for such changes.

Mr. REISCHAUER. We get into the very difficult issue of who is making the investment decisions? Is it a government agency? Is this corporation run by the private sector? There were complaints about the RFC, remember, that some of its investments were guided by political as opposed to economic considerations during the war.

Senator SANFORD. I would have a provision in here that we couldn't have a political figure in that job.

Well, my time is up. But I would like to send you material on this idea and have you give us an opinion if you wouldn't mind.

Mr. REISCHAUER. We'd be glad to do that.

Let me just make an observation about the statement you made that increased premiums necessarily, dollar for dollar, weaken bank profits.

That isn't necessarily so. Some of the increased assessments will be pushed off onto the consumers and depositors in the form of higher loan rates and lower interest payments. And the failure rate that we assume in our projections that results from increased premiums, of course, is sensitive to what fraction of that increase is expected to come out of the capital of banks and what fraction of it is expected to be pushed off onto those who use bank services.

Senator SANFORD. My time's up.

The CHAIRMAN. Thank you, Senator Sanford. I think those ideas that you've put out there are ones that the committee is going to be considering and taking a look at. And I see in the paper this morning that there are similar discussions apparently going on within the FDIC and other places today, trying to see what other avenues might be open to us here.

Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Dr. Reischauer, as you know, there have been a number of thoughtful proposals over the years to require that the Federal Reserve pay interest on money that it now holds as reserves for banks. The Fed requires the banks to put up these reserves, which the Fed holds. But, the Fed does not pay banks any interest on it.

Now, there have been proposals that the Fed pay the banks interest on these funds they hold. And that might be a good idea. But, my question to you is:

What would be the budget implications of this?

At the present time, the Fed earns interest on those funds which they turn, at least a portion of, over to the Federal Treasury. If I'm not mistaken, these funds then lower the deficit.

What would be the budget impact if the Fed paid banks interest on the reserves that they hold and, in that way, did not collect the interest on the reserves themselves?

Mr. REISCHAUER. The proposals of which you are speaking really are a form of backdoor Treasury recapitalization, in effect, taxpayer recapitalization. The profits of the Fed are turned over to the Treasury. If the Fed paid interest on these reserves, those profits would fall by a little over $2 billion. The Federal deficit would increase by several billion dollars as a result.

Senator SASSER. Well, can we be more precise than "several billion"? Are we talking about $2 billion? Three billion dollars? Five billion dollars?

Mr. REISCHAUER. Oh, excuse me. We're talking about $2 billion to $2.5 billion.

Senator SASSER. So the deficit would increase by $2 billion to $2½ billion?

Mr. REISCHAUER. Correct.

FEDERAL BUDGET DEFICIT

Senator SASSER. What is the Federal budget deficit going to be for fiscal year 1992?

Mr. REISCHAUER. For fiscal year 1992, it will be a little bit under $300 billion, closer to somewhere between $280 billion and $290 billion. And that estimate presumes that the discretionary spending caps that were agreed to in the Omnibus Budget Reconciliation Act of 1990 are maintained. It also excludes the 1992 costs of Operation Desert Storm that are not reimbursed by allied contributions.

And so, if you think there will be substantial costs over and above those that were offset by allied contributions, you would have to add those costs to the $280 billion to $290 billion.

In other words, it's going to be a record-level deficit, like the one for the current fiscal year.

Senator SASSER. Let me be clear that I understand this. You're predicting for fiscal year 1992 at the present time a Federal budget deficit of between $280–$290 billion. But that does not include unreimbursed costs for Operation Desert Storm?

Mr. REISCHAUER. Correct.

Senator SASSER. In other words, if we have a cost in fiscal year 1992 of $30 billion for Operation Desert Storm and our allies reimburse us $10 billion, then we would have a $20 billion deficit. Added onto the $280–$290 billion figure?

Mr. REISCHAUER. Correct.

Senator SASSER. I just wanted to make that clear for all of my colleagues here this morning to underline the difficulty we're having with the deficit and the fact that this deficit is going up on us.

Could you put that deficit in historical perspective for Dr. Reischauer?

Mr. REISCHAUER. The largest deficit that this country ever experienced, I believe, was fiscal year 1986, and that was a $221 billion

deficit. In the current fiscal year, the deficit will probably be between $290 billion and $300 billion, excluding extra expenditures for Operation Desert Storm. That will be the largest deficit in U.S. history. In nominal terms, it will amount to somewhere around 5.3 percent of GNP, which is very large by historical standards, although not the highest percentage that we have ever experienced.

Senator SASSER. When was the highest percentage? During the Second World War?

Mr. REISCHAUER. In terms of a percentage of GNP?

Senator SASSER. Yes.

Mr. REISCHAUER. Yes.

Senator SASSER. But this would be the highest percentage of debt to GNP that we have experienced since the Second World War? Or, since 1986?

Mr. REISCHAUER. Oh, no. I believe the share in 1982 or 1983 was close to 6 percent, a little over 6 percent of GNP. But, remember, that the country was then in the depth of a very serious recession, one several times the magnitude of the current recession.

Senator SASSER. Yes, some call that a depression in 1981-82. It was the worst economic downturn, I think we all are agreed upon, since the Great Depression of the 1930's.

My time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

One of the issues that we have been focusing on for sometime in this committee is the issue of bank capital levels. The main recommendation we have received from probably the largest number of people with varying degrees of enthusiasm is that:

If banks have high enough capital, they're going to be OK. Capital is your firewall, the essential firewall against risk.

Those who believe that it's important for banks to be able to go beyond normal commercial banking, say, that capital is your safeguard if banks branch out into other activities through separate subsidiaries because capital is the means of protecting the Federal Deposit Insurance System.

I am puzzled by the fact that many of our Nation's most highly capitalized banks, most notably those in Texas, are the ones that have failed. I refer you to the FDIC banking review, winter 1990, which has an absolutely fascinating series of charts and articles in it on this.

And it says, and I quote: "Equity capital ratios for the nine organizations"—these are Texas banks—"were on average over 25 percent higher than those of their peers between 1980 and 1982."

These particular institutions are the ones that failed.

Based on our experience, therefore, to date, what confidence do we have that higher capital levels without other reforms, and that's what we're all struggling to develop, will, in fact, be sufficient to protect the deposit insurance system?

Mr. REISCHAUER. You obviously have no ironclad assurance, as these numbers point out, but several other things were going on. In 1981 and 1982, the United States was in a serious recession. That was also a period in which some believe that there was a great deal of laxity in State regulation in Texas.

Senator HEINZ. These were for the most part national banks.

Mr. REISCHAUER. National banks? I would add that the country went through some very peculiar economic circumstances—of a tremendous boom associated with the oil price rise, and then a tremendous bust——

Senator HEINZ. Because I've got a lot of other questions I want to get in in a short time, let me paraphrase your answer, which is:

Yeah, there are other factors that make capital blow away real fast.

OK, I think that's right. I think you've made your point and I think it's self-evident. I just wanted it to be on the record.

Mr. REISCHAUER. The regulators should reassess the situation periodically, and when economic circumstances are changing rapidly this reassessment should occur frequently.

Senator HEINZ. Is it possible on the other end of the scale that there is a point at which higher capital levels become counterproductive? That is to say, they make it too costly for a bank to raise capital and exist? Is there such a thing as a capital level that's too high?

Mr. REISCHAUER. I don't think there's a threshold, but that certainly is correct. The more capital you require, the more difficult it will be to earn a high rate of return and the less attractive the banking industry will be. And so you're balancing off these two conflicting objectives.

SELLING OFF ASSETS

Senator HEINZ. In an effort to raise capital rather than I guess in many instances go to the market to raise it, some industry observers have noted that banks are shedding their good assets and they're keeping the poorly performing assets as a means of raising that capital.

While I guess that may provide some kind of a cosmetic fix, I have got a real concern that's twofold.

One, that they're destroying their franchise values, but more importantly, that they are ultimately increasing costs to the Bank Insurance Fund when they fail.

Do you share those concerns?

Mr. REISCHAUER. I share those concerns, correct.

Senator HEINZ. In your testimony on page 2, you talk about this subject. At an RTC oversight hearing last week, Alan Greenspan, who appeared before us, suggested that there are strategies available to the Federal Reserve other than lowering interest rates, which everybody, as far as I can tell, favors except maybe the Fed, that may assist in relieving the so-called credit crunch. I would say editorially that what I have described many banks as doing, namely, calling their good loans and hanging on to their bad ones, is an important part of the credit crunch.

Going back to these alternatives that Alan Greenspan alluded to, he was not specific. But would you care, to speculate, at least theoretically, as to what other potential strategies might be available to the Federal Reserve to address this credit crunch as we've discussed it, described it; that is, what suggestions would you have if you were head of the Fed?

Mr. REISCHAUER. I certainly wouldn't take this ocassion to advise Mr. Greenspan on what he should do, but I would note that——

Senator HEINZ. Be our guest.

Mr. REISCHAUER [continuing]. Reserve requirements have been liberalized, and that is expected to increase bank profitability. That action was also intended, I think, to send a signal to the banking industry. I think also that his public statements suggest some kind of moral persuasion—that he is concerned about the possibility of a credit crunch and the possibility that banks are overreacting to the environment in which the country finds itself in a way that is counterproductive.

Senator HEINZ. Are there any other potential levers he has to act if reducing Reserve requirements or jaw-boning the banks doesn't work? Are there some other mechanisms that he can manipulate or use?

Mr. REISCHAUER. I believe he could change the rules regarding collateralization when banks borrow. Right now, they are very stringent. They require, for all practical purposes, more than full collateral to be put forward. These rules could be eased.

Senator HEINZ. There may be others. And if you have them, please supply them for the record.

One of the things that occurs to me is that these powers that you've suggested that indeed are available to the Fed bring up the subject of the creation—it's advocated by some, not by me—of a so-called Reconstruction Finance Corporation, which would work by putting capital into the banking industry to help alleviate the credit crunch.

Those who advocate this position note that banks are unable to raise capital in the securities markets and, therefore, because they can't do that, they're shrinking the balance sheet, as we discussed a moment ago, as a means of raising capital.

And, of course, that exacerbates the credit crunch.

Do you advocate or look with favor on the creation of an RFC of this type?

Mr. REISCHAUER. As you know, we don't endorse or cast aspersion on specific policies. I think there are a lot of reasons to be very hesitant about that approach. And I think the basic one goes back to the question I raised earlier, which is: Are you merely postponing the inevitable? And are you postponing an evolution and a consolidation that, while painful in the short run, over the long run will make the banking industry more efficient and stronger?

Senator HEINZ. Mr. Chairman, I thank Robert Reischauer for his answers. There are two questions that I would like to submit to him in writing. One concerns the value of a bank franchise and whether actions to either narrow or expand the scope of bank powers—product, geography, and so forth—might or might not have on the value of a bank franchise.

The second has to do with whether or not we should put the Bank Insurance Fund in such similar enterprises on an actuarial basis and whether there are any precedents for it in government.

Mr. Chairman, thank you very much.

The CHAIRMAN. Thank you, Senator Heinz.

We will look forward to your answers to those two questions.

Senator Sarbanes.

FIRST LINE OF APPROACH

Senator SARBANES. Thank you very much, Mr. Chairman.

As I read your testimony, I gather that it's your view that, at least as a first line of approach, that the FDIC will need to borrow from the Treasury or remove the restriction that limits its line of credit.

Is that correct?

Mr. REISCHAUER. That's correct.

Senator SARBANES. That's your first line of approach.

Mr. REISCHAUER. Yes.

Senator SARBANES. And you then are assuming—well, let me just quote your sentence to you:

> Borrowing, which would require repayment with interest, would permit BIF to meet its obligations over the next few years while allowing the industry a longer time to cover those costs with its premium payments.

So, in effect, what you're saying is: Well, they can't meet the costs in the short-run with their premium payments that's needed to address this crisis, but if you make these borrowings over the middle term through the premium payments, they will, in effect be able to meet the costs of that borrowing, and the other costs I assume that are being incurred.

Is that correct?

Mr. REISCHAUER. Yes. That's correct. And we've assumed that——

Senator SARBANES. What is your economic scenario on the basis of which that—or your economic assumptions on the basis of which that scenario is projected?

Mr. REISCHAUER. Our basic economic assumptions involve a mild recession over the last quarter of 1990 and the first quarter of 1991, and then what I would characterize as moderately healthy growth of around 3 percent for the ensuing years of our forecast. We then have translated——

Senator SARBANES. Well, how many years—how many years—are involved in this workout that you're projecting under this first line of approach?

Mr. REISCHAUER. We're suggesting that this can be done in the timeframe of our projections, which go through 1996.

I should hasten to add——

Senator SARBANES. So you're projecting an economy then that comes out of this recession when?

Mr. REISCHAUER. In the second quarter of 1991. In other words, the last quarter of 1990 will, as the preliminary numbers from the Bureau of Economic Analysis indicated, show a decline in real GNP as will the current quarter. And then we'll see a slight increase in real GNP in the second quarter of this year.

Senator SARBANES. So you come out of the recession in the second quarter of this year and then you're projecting 3 percent growth through each year through 1996?

Mr. REISCHAUER. The growth will be slightly above 3 percent as we come out of the recession; then it will drift down into the high 2.7 percent to 2.8 percent range in 1994, 1995, and 1996.

Senator SARBANES. Well, how realistic a projection do you think that is?

Mr. REISCHAUER. Well——

Senator SARBANES. I mean, we're being counseled now, as I understand your testimony, to support a borrowing route for the Bank Fund; that is, to go to the taxpayers. I take it we're being told:

Well, now this isn't really going to end up being a charge on the taxpayer because over the next 5 years, 4 to 5 years, the payments in by the banks into the Fund on their premiums will be enough to take care of this in a sense advanced or temporary borrowing.

Of course, that then raises a question:

Well, what are your economic assumptions on the basis of which all of this is going to happen?

And how realistic is it to project this 3 percent growth, sustained 3 percent growth, year to year over a 4- to 5-year period?

Mr. REISCHAUER. Our forecasts are not appreciably different from what's called the Blue Chip consensus, which is an average of private forecasters. [Pause.]

I mean, you can ask how realistic are economists when you line them end to end.

Senator SARBANES. Well, that's——

Mr. REISCHAUER. And if that's the answer——

Senator SARBANES. That's like John Kenneth Galbraith's statement the other day talking about—they asked him about some economist who had been up here on the Hill testifying before a committee and projecting where the economy was going to go. And he said: "Well, there are two kinds of those economists: those who don't know and those who don't know they don't know."

Mr. REISCHAUER. I would hope we're in neither of those categories.

Senator SARBANES. I hope not, too.

Mr. REISCHAUER. What we have is the economy recovering from what is a rather significant gap between actual GNP and potential GNP. We have potential economic growth really of only around 2.2 percent, which is regarded by many, particularly in the administration, as a rather pessimistic, long-run outlook for the future productive capacity of our economy.

Senator SARBANES. Well, my time's almost up. Let me ask you one final question.

You say on page 17 of your testimony: "Moreover, any new legislation dealing with bank powers could have significant long-term effects."

You don't say what you think those significant long-term effects would be. What do you think they would be?

Mr. REISCHAUER. It would depend very much on the nature of the banking reforms that were instituted. But, presumably, the reforms either in the deposit insurance system or in the powers and regulatory framework in which banks operate would be designed to increase the profitability of the industry and its efficiency, and also to reduce the risk faced by the Bank Insurance Fund.

FINANCIAL SITUATION OF THE SECURITIES INDUSTRY

Senator SARBANES. What do you understand the current financial situation to be in the securities industry and in the insurance industry?

Mr. REISCHAUER. We haven't done a study of either of those.

Senator SARBANES. Well, just from reading newspaper accounts——

Mr. REISCHAUER. From reading newspaper accounts, you would assume that, relative to their financial situations during the early and mid-1980's, they're on shaky ground. And this has been clearly shown by the retrenchment that's taken place in the securities industry—and the reduction in employment and the general contraction that has occurred with respect to the insurance industry. There industries obviously are facing some of the same problems that the banking industry is facing with the deterioration in real estate values—and with some of the contracts that they entered into guaranteeing returns on pension funds in the past. From what I gather from the newspapers, this is a problem. It's something worth keeping our eyes on, but it isn't expected by the experts to develop into a crisis unless the economy weakens more significantly than we or the majority of economists think will be the case.

Senator SARBANES. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Sarbanes.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Chairman, I have an opening statement which I would like to file for the record.

The CHAIRMAN. We'll make it a part of the record.

OPENING STATEMENT BY SENATOR BOB GRAHAM

Senator GRAHAM. Mr. Reischauer, it is a pleasure to have you before our committee today. The last time you appeared before us, you told us we had a $21 billion need to be covered by the Bank Insurance Fund.

At that time I expressed a sense of urgency about this issue and I asked you to lay out a plan of action for the Congress to follow before it adjourned in October. You did. You provided the following list starting at the bottom:

Provide the FDIC with increased borrowing authority or an ability to generate working capital.

You want to be careful as you increase the maximum premium simply because, in the short run, you don't want to make the situation worse. You don't want to push some weak banks, which are otherwise recovering, over the brink.

The number and capability of the staff is an important issue.

Strengthen the data collection system.

Congress did none of those things. I will look forward to asking you to update your list in my question and answer time and to give a timeframe by when you think Congress should act.

We look forward to your testimony today.

Last September, when you appeared before this committee, I asked your judgment on emergency actions which the Congress should take before it adjourned in 1990. You responded to that question, as follows:

Provide the FDIC with increased borrowing authority or an ability to generate working capital. You want to be careful as you increase the maximum premium simply because, in the short-run, you don't want to make the situation worse. You don't want to push some weak banks which are otherwise recovering over the brink. The number and capability of the staff is an important issue. And, strengthen the data collection system.

Those were the four items that you mentioned in response to that question.

I'd be interested in your evaluation of how well Congress in 1990 reacted to those four suggestions. And, second, what would be your agenda for 1991?

Mr. REISCHAUER. With respect to the most important suggestion which was to provide increased borrowing authority, the Congress in the Omnibus Budget Reconciliation Act did provide the FDIC with authority to go to the Federal Financing Bank for certain borrowing up to limits that were dependent on its asset values and its positive net worth.

This authority, in a sense, will enable the FDIC to generate some working capital but not to get through the liquidity crisis that CBO's suggesting faces the Fund toward the end of this calendar year.

And so I would come back on both this front and the other three suggestions that I made and sing exactly the same song once again. Four or 5 months have gone by, and I don't think there's any reason to change the tune.

Of course, the premiums have been raised. And that was part of the Omnibus Budget Reconciliation Act as well. And we have assumed that they will be raised further in the future.

And the limitations that were on the increases in premiums set by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) were removed. That provides the FDIC with more flexibility than it had, which is, I think, a step in the right direction as well.

Senator GRAHAM. In yesterday's New York Times, there was a column entitled, "Banks Are Looking a Lot Like S&L's," in which Professor Edward Kane of Ohio State reviewed some of the similarities. He made these following recommendations for action.

First, Federal bank regulators must be required under penalties of fraud to make an honest and timely reporting of deposit insurance losses as they accrue.

Second, banking officials must be obligated to force rapid recapitalization of the Insurance Fund and of troubled institutions of all sizes every time their capital falls below minimum acceptable levels.

Would you comment on those two recommendations and the degree of your agreement with Professor Kane's assessment of their importance?

TIMELY DISCLOSURE OF DEPOSIT INSURANCE LOSSES

Mr. REISCHAUER. I don't think anybody's going to argue against rapid and timely disclosure of the true situation.

Senator GRAHAM. His point in the article is that we haven't had that to date. Do you agree that that's a legitimate criticism?

Mr. REISCHAUER. I think it is a legitimate criticism of the way that the FDIC goes about its normal business. There is a certain amount of discretion as to exactly when you close the Bank of New England, as Senator Heinz pointed out. And the losses are known beforehand. In a sense, we know this is a bank headed for the wall. Except in a sense we don't know. The Members of Congress and the analytical community aren't always as knowledgeable as the regulators as to exactly where the problems are and what their size might be.

And, certainly, some improvement along those lines would be in order. I had suggested that the last time I was testified before this committee.

With respect to the suggestion for rapid recapitalization when the Fund falls below a certain level, I think here you have to ask yourself: Who is going to recapitalize the Fund?

And if there is a demand that it be recapitalized quickly once the Fund experiences a significant drop, then you're more likely to be saying that the taxpayer should play a major role in recapitalization. Although if one looks at the problem over a longer period of time, as I've suggested in my testimony and in our projections, the industry itself might be better capable of recapitalizing the Fund, though it may not be able to deal with the immediate liquidity problems that the Fund faces.

Senator GRAHAM. Mr. Chairman, my time is expired. I would like to ask that the full text of the article from yesterday's New York Times, "Banks Are Looking A Lot Like S&L's", be included in the record.

The CHAIRMAN. Without objection, so ordered.

[The document follows:]

NEW YORK TIMES - P. A-23 - 1/28/91

Banks Are Looking a Lot Like S.& L.'s

By Edward Kane

COLUMBUS, Ohio

Bankers proudly distinguish themselves from their counterparts in the savings and loan industry. Federal officials take offense at comparisons between the Federal Deposit Insurance Corporation and the bankrupt Federal Savings and Loan Insurance Corporation. But these distinctions and protests are sounding increasingly hollow.

The F.D.I.C.'s current condition resembles that of F.S.L.I.C. 12 years ago. The F.D.I.C. manages to report reserves of roughly $9 billion — but only through extremely optimistic estimates of its exposure to losses at insured banks. A recent report prepared for the House Banking Committee estimates that, allowing for this exposure, the F.D.I.C. fund is actually in the red by $31 billion to $63 billion "or more." Last week, even the White House conceded that the fund will have a shortfall of $23 billion by 1995.

As the F.S.L.I.C. did throughout its final decades, the F.D.I.C. is taking advantage of accounting and regulatory discretion to conceal from taxpayers the fact and depth of its insolvency. During the media blitz that followed the Federal takeover of the Bank of New England, the F.D.I.C.'s chairman, William Seidman, dismissed such allegations. He maintained deceptively that the fund had ample reserves to handle foreseeable failures.

In a sense, this is true. Since the F.D.I.C. controls the timing of individual bank failures, it has the power to define what is foreseeable. Moreover,

Two ways to avoid the same trap.

the agency controls the size of the asset writedowns it records against its reserves by how it structures a bank rescue package. So it also defines the size of the failures.

For years, the F.S.L.I.C. kept its problem list at "manageable" levels by looking past similar accounting gimmicks. Recent dramatic improvements in the F.D.I.C.'s list of problem banks indicate that this agency is slipping into the same rut.

Despite falling real-estate prices, collapsing junk-bond values and a developing recession, the F.D.I.C. claims that the number of problem banks fell from 1,406 at the end of 1988 to 1,034 at midyear 1990. During the first six months of 1990, the assets of insured banks whose net worth registered below 3 percent of their assets — a level known to trigger F.D.I.C. discipline — shrank from $125 billion to $30 billion.

What's really going on? Deeply troubled banks are kicking themselves out of the F.D.I.C.'s low-rated categories by resorting to accounting gimmicks or by selling their strong assets, on which they have capital gains. In many cases, this legerdemain not only masks their true economic condition but actually makes it worse.

The F.S.L.I.C.'s fatal mistake was to allow insolvent "zombie" S.& L.'s to operate for long periods with federally insured deposits. Because fur-

ther losses generally accrue to taxpayers, the zombies are eager to pay dividends and are inordinately attracted to risky investments and loans. The taxpayers' stake in an insolvent enterprise is not properly balanced because the zombies retain the returns whenever risky strategies pay off handsomely.

The zombie syndrome is a trap that deepens when insolvency resolution is slow or inadequate. In 1980, problem banks spent an average of only 15 months on the F.D.I.C. problem list. By 1989, the average was 28 months.

In sum, growing F.D.I.C. losses are directly traceable to bureaucratic gambling. And when the bill comes due, taxpayers will have to fill in the $30 billion to $60 billion gap that now exists between F.D.I.C. assets and loss exposures — unless Congress explicitly finances the burden in another way.

To stop this gambling will require two changes in the way the F.D.I.C. does business. First, Federal bank regulators must be required, under penalties of fraud, to make an honest and timely reporting of deposit-insurance losses as they accrue. Second, banking officials must be obligated to force rapid recapitalization of the insurance funds and of troubled institutions of all sizes every time their capital falls below minimum acceptable levels.

In his State of the Union Message tomorrow, President Bush is expected to propose a drastic overhaul of the banking system. In the absence of these two critical reforms, however, such measures as adjustments in coverage levels, risk-based premiums, interstate banking and reorganizations of the regulatory bureaucracy will provide little real protection for taxpayers. □

The CHAIRMAN. Senator Sanford.

Senator SANFORD. Thank you. Let me go back to Senator Sasser's questions just for a moment before I come back to the banks.

You said that you gave the figures on the budget deficit. What will be the figure of the increase in the public debt, total debt, subject to limitation, in this year's, budget?

Mr. REISCHAUER. It will basically be the deficit numbers, if we're talking about the total amount of debt as opposed to the debt held by the public——

Senator SANFORD. No, no, I'm talking about the total amount of debt. That's what we owe.

Mr. REISCHAUER. It will be the deficit number—in other words, slightly less than $300 billion, plus whatever costs of Operation Desert Storm are not paid for by contributions by our allies, plus the surplus in the Social Security trust fund, which will be a bit over $60 billion. And so a number around $360 billion plus Operation Desert Storm would be——

Senator SANFORD. So we really might be looking at—excuse me. Go ahead. You're looking at a figure you're going to give me?

Mr. REISCHAUER. Well, I'm looking at a figure that won't be released until tomorrow.

Senator SANFORD. Well, write it down on a piece of paper. [Laughter.]

The CHAIRMAN. Write it down on three pieces of paper.

Senator SANFORD. Write it down on a piece of paper. I'll take it with me.

It's bad news in any event, isn't it?

Mr. REISCHAUER. Yes. You wouldn't invite me here if you didn't expect to hear bad news.

Senator SANFORD. Well, that's right. I think one of our big problems has been that we've been fooling ourselves about the pile-up of the national debt. It doesn't make any difference whether we owe it to a Trust Fund or owe it to the public. I think that we are misleading ourselves. That's really my point and, as you know, has been my point for 4 years. I believe we need an honest budget that honestly reflect our true debt.

But, I can wait until tomorrow.

Mr. REISCHAUER. I'll spring it on you now. The number for debt subject to limit, the increase between 1990 and 1991, will be $404 billion.

Senator SANFORD. And in this projected budget?

Mr. REISCHAUER. For 1992? About $415 billion.

Senator SANFORD. Well, let's get back to real life now.

Mr. REISCHAUER. Unfortunately, that is real life. [Laughter.]

Senator SANFORD. Real death.

I have problems with the RFC concept, but I have even more problems with simply bailing out banks and saying that that failure is going to be inevitable. Let me just ask you this basic question:

Do you think we need more capital in the banking industry?

Mr. REISCHAUER. I think the banking industry is undercapitalized at present, yes.

Senator SANFORD. And we are interested in that——

Mr. REISCHAUER. But that's concentrated in a rather small segment of the industry.

Senator SANFORD. But, nonetheless, it could——

Mr. REISCHAUER. We also should be aware of the fact that, under the Basle Accord, we are going to go to risk-based capital standards, which should force an increase in capital on average in the industry.

Senator SANFORD. Well, that's exactly right. And looking for orderly ways to get capital on a fairly hurried basis is the reason I've been trying to find some approach to bring in new capital. One idea has been suggested by the bankers; another by Felix Rohatyn; another by FDIC Chairman Seidman.

Now, there are three things bad about these ideas.

The banks might not want it, as Senator Heinz suggested. They might not want to reduce the earning capacity of the present stock. Also as you said, it's postponing the inevitable of shaking out the weak banks.

And the concern third, that most people have raised with me, is: Yeah, but who makes these life and death decisions?

What else is an argument against the RFC approach?

RFC APPROACH

Mr. REISCHAUER. I think we need to define exactly what is meant by the RFC approach. If we want to infuse new capital into the banking sector, there are really two sources it can come from. It can come from private sources outside the banking industry, or it can come from the Government.

Some of these proposals suggest that it will come from the banking sector itself, that the banking industry will assess itself a 1-percent levy, and this will go into an RFC-type organization that will then recapitalize weakly capitalized banks that otherwise are rather sound institutions. That's really just shuffling the same pot of capital around among different institutions. And that doesn't get us anywhere.

Whether sectors outside the banking industry are interested depends on the perceived profitability of this sector. And that, in some sense, might depend on what this committee does later this year with respect to restructuring the powers and authorities of banks, as well as the changes that might be made in deposit insurance.

Senator SANFORD. Thank you very much. I'd like to pursue this with you, and will. These question and answer periods never are quite adequate.

But, thank you very much.

The CHAIRMAN. Thank you, Senator Sanford.

Let me—I want to try to nail down 3 or 4 points in the time that we have left and then go back to my colleagues here.

If I understand your answer to Senator Sanford, your freshest, your most up-to-date projection now, is that we're going to have to add $404 billion of new debt, new Federal borrowing net of all activity for the fiscal year we're now in.

Is that—did I hear you properly on that?

Mr. REISCHAUER. Without trying to get into an argument with Senator Sanford, some of this borrowing will be intragovernmental borrowing. The Trust Funds invest in Government securities. That is not borrowing that affects the economy at large because it doesn't drain the savings of the private sector.

What we should keep our eye on is the $300 billion, not the $400 billion, if we're concerned about the economy as opposed to being concerned about——

Senator SANFORD. Grandchildren. [Laughter.]

The CHAIRMAN. Well, or said another way, I mean, you know, we're looting the Trust Funds. I mean, you know, we can dress it up any way we want and say it's intergovernmental borrowing. The point is we have taken the money in for one purpose, and then we're borrowing it out of the Social Security Trust Fund and taking it over and spending it somewhere else.

So, that the money's been spent. An obligation has been created at some point to pay that Trust Fund back because the people who draw on the social security moneys that presumably are accumulating have a claim on that money.

But I don't want to get distracted in that. What I want to know is your best estimate as to how much—first of all, I want to know your latest sense for what the fiscal deficit is going to be for the fiscal year that we're now in.

Mr. REISCHAUER. As I said, for the current fiscal year, the deficit should be between $290 billion and $300 billion, except for this great unknown. And the great unknown is how much we will spend on Operation Desert Storm that will not be reimbursed by cash contributions from our allies.

The CHAIRMAN. And then, but you went beyond that and you said that if you also do the borrowings from the Social Security Trust Fund, you got up to a figure, your best estimate was something on the order of $370-380 billion.

Didn't I hear you say a figure in that range?

Mr. REISCHAUER. Correct.

The CHAIRMAN. So we're pushing $400 billion in terms of a deficit figure the way I've just described it with the borrowings from the Trust Fund.

Do you have a separate estimate now as to how much the outstanding Federal debt in total will likely rise by the end of the fiscal year? Is that in the $400 billion range, too?

Mr. REISCHAUER. The total debt subject to limit at the end of the fiscal year should be around $3.565 trillion.

The CHAIRMAN. And that will be up what from——

Mr. REISCHAUER. That will be up, as I said, $404 billion from the previous year. But that's the debt subject to limit, not the debt held by the public. And the debt held by the public will rise from $2.41 trillion to $2.693 trillion.

The CHAIRMAN. Do you subtract one from the other? Do you have that increase then? Can you give me that in round numbers?

Mr. REISCHAUER. $283 billion.

The CHAIRMAN. Now that's $283 billion, but that still leaves aside, does it not, the question of Desert Storm?

Mr. REISCHAUER. Correct.

The CHAIRMAN. So there are some uncertainties.

And I still think it's important to note that the Government with the payroll tax takes in money for social security payments and then taps that money in intergovernmental borrowing and spends it on something else. It doesn't create a new borrowing from the public, for all practical purposes, because we've spent the money on a different purpose. And at some point in time, we're going to have to replace that money.

But, I don't want to persist in that argument right now. I'm more concerned about the fact that we're looking at a $400 billion—or something in that area—of fresh deficit accumulation.

If I heard you right, in the following fiscal year, you anticipate that even with a somewhat more buoyant economy the figure will be in the same range. I think I heard you say $415 billion or thereabouts for 1992.

Did I not hear that?

Mr. REISCHAUER. What I was giving you here was the debt subject to limit, and that has a lot of minor adjustments that have to do with certain kinds of agency debt that's included or excluded compared.

The CHAIRMAN. There's always a danger in trying to oversimplify, but it looks to me as though over a 2-year period there's going to be two back to back $400 billion deficits—or $800 billion, something approaching a trillion dollars.

Mr. REISCHAUER. If we're talking about the deficit as defined in the Budget Omnibus Reconciliation Act, which excludes the Social Security Trust Fund surpluses, you're right. If we're talking about the deficits that matter from an economic standpoint, that burden private financial markets, then we're talking about deficits a little below $300 billion for the current fiscal year, and a little below $290 billion for fiscal year 1992, plus Desert Storm costs. And those costs are anybody's guess.

The CHAIRMAN. How much of that additional debt financing do we normally rely on foreign lenders to give us? Is there a rough percentage? Twenty percent? Thirty percent? Forty percent?

Do you have a figure that you use?

Mr. REISCHAUER. I don't have it. It varies tremendously year to year. And I believe that in certain years foreigners are net sellers of U.S. securities. The Japanese, for example, in the last year have been net sellers of Treasury securities.

And so, you know——

The CHAIRMAN. Chances are though that, unless people jack up their savings rate, or more money to save, that we're going to have to get some of this money from foreign lenders?

Mr. REISCHAUER. The total amount saved in the United States certainly is much larger than the Federal deficit. What happens when we're in a recession is that private demands on the savings tend to fall as businesses and individuals don't borrow as much as they would otherwise, thereby, freeing up added resources for the Federal Government.

The CHAIRMAN. Well, I don't want to stay on this much longer because to do it would take us another 45 minutes, and we don't have that time.

But I would say that one of the things that concerns me is not only the fact that these deficits continue to run these extraordinar-

ily high figures when the ink is barely dry, despite so-called budget fixes. And now we've got these extra costs of an unknown size in Desert Storm. So I think we're approaching the outer bounds of of added costs that can be absorbed in an orderly way, especially when you see so much structural weakness in the banking system.

One of the things that concerns me is that, while we have a lot of banks out there that are in solid condition, we have a significant number that are not. And we don't have to have all the banks fail at once to create a real threat to the system.

And I was just re-reading Alan Greenspan's testimony here last week to us in this committee. And he was obviously picking his words very carefully, as he does. He didn't want to frighten the credit markets.

But he was expressing a real concern about the cross-connection between the economic downturn and the problems in the banking structure. There is something of a credit crunch in some parts of the country. These things are interacting with one another to take the economy down at a faster rate.

You're saying that what we may have to face is a temporary exhaustion of the Insurance Fund and be prepared to create a standby line of credit. If the Fund goes underwater, which you predict it will, there should be a way to borrow money while it's underwater with the hope that it will just be underwater for a while. Then it will come back up again and you will have bridged this problem by some modest amount of borrowing to maintain the liquidity of the Bank Insurance Fund.

Now, that's the proposition that you've advanced. If the numbers work out, I think that's a reasonable alternative. It may not be the best choice. I don't think we can judge that just yet. We've got to look at all the other choices that we have—how much the banks can contribute, and so forth.

It is a stunning development that we're having to recognize that the Bank Insurance Fund may, in fact, become a new source of debt accumulation.

When I hear that the economic projections as to how large that draw-down might be vary quite a bit over the next 2 or 3 years, depending on whether the economy bounces back in an orderly way.

Now, have I summarized more or less accurately what I think you're saying to us here today?

Mr. REISCHAUER. Yes. But I think some people might interpret what I've said as being alarmist, and so let me try and rephrase some of the observations that you've made.

The Fund will need to borrow over the next several years, not all in a single year, something like $11 billion. Should the recession prove to be quite severe, the borrowing might have to go up as high as around $38 billion or $40 billion—in other words, $27 billion or $28 billion above the baseline numbers, which are built into our deficit estimates. So we don't want to double-count those.

The CHAIRMAN. Right.

Mr. REISCHAUER. Another point that I would make is that the large deficits that we've been talking about and are certainly a real cause of concern——

The CHAIRMAN. May I just stop you right there because this is very important and I want to make sure our record is clear on it.

You see the Fund going into deficit somewhere between $11 billion and $40 billion over the next 3 or 4 years. And that's based on not only your assumptions of a somewhat mild recession and then recovery, but also an increase in Bank Insurance fees. That was another part of your plan.

But, despite that increased income to the fund you still see a range of an $11 billion to a $40 billion deficit that's going to have to be covered over a 3- to 4-year period.

Is that accurate?

Mr. REISCHAUER. Yes. I wouldn't put the range that high because we do not expect the severe recession of the sort that we have estimated here. What we really would expect is numbers around $11 billion. Some of the deterioration in the Fund, remember, is associated with the assumption of assets that will later be sold. In other words, some of it is working capital. And so we shouldn't view what we're talking about here as a total loss.

But, the other points that I want to make are, first of all, that the terrible deficit numbers for the current fiscal year and the next fiscal year are largely the result of temporary factors, two in particular. One is obviously the hemorrhaging of the deposit insurance accounts. Most of the spending is not by the Bank Insurance Fund, but rather is by the RTC and FSLIC Resolution Fund for savings and loan problems.

Those deposit insurance expenditures will be adding something in the neighborhood of $100 billion to our deficit in the current fiscal year. And those expenditures have very different economic repercussions than does borrowing money to increase food stamps or to buy a new M1 tank or whatever. The borrowing does not increase the wealth or incomes of the people and institutions that benefit from it.

And, in fact, the borrowing is likely to be recirculated very quickly back into financial markets and, therefore, have little or no impact on interest rates. So we don't have to be as concerned about this source of the deficit as we are about the simple fact that we aren't taxing ourselves sufficiently to pay for the immediate goods and services that we as a nation are consuming.

WEAKNESS IN THE ECONOMY

The second factor contributing to the terrible deficit numbers for this year and next, of course, is the weakness in the economy. We estimate that the deterioration between our July forecast and our January forecast will add something in the neighborhood of $50 billion to the current fiscal year's deficit. And that, of course, is a temporary phenomenon.

The next point that I would like to make is that, while the short run looks terrible with respect to the deficit, the long run looks pretty good. A substantial amount of progress was made in the 101st Congress to bring the deficit down.

And there's every reason to believe that, if the Congress sticks with the budget agreement, stays within the discretionary spending constraints that were laid out in that agreement, and maintains

the pay-as-you-go discipline that is required for entitlement and revenues in that situation, by 1995 we will have a deficit in this country that is below $100 billion, and below 1 percent of GNP. It will be the first time in 20 years that the deficit has fallen below 1 percent of GNP.

Nobody wants to stand up and say that we did a good job last year when the numbers spewing out of Treasury on the deficit are the largest ever experienced in our history. But the fact of the matter is that substantial progress was made, and credit should be taken for it. It has set us off in the right direction for reducing the deficit, increasing the national saving rate, and doing something about future standards of living for our grandchildren.

The CHAIRMAN. Well, I hope it turns out that way. We all do, certainly.

I'm going to yield in just a second to Senator Graham, but I want to make just a couple of observations about it. And that is that, in a sense, we've heard that song before. Now, the facts are different.

Mr. REISCHAUER. I don't think you've heard that song from the Congressional Budget Office before.

The CHAIRMAN. Well, that may well be right. But we've heard it from a lot of witnesses.

Mr. REISCHAUER. As you said, the ink is not yet dry on this agreement, and what I'm saying is that if the Congress carries it out and the administration doesn't take out its eraser and try and erase the ink, we should be headed in the right direction. And we should see the deficit begin to fall rather substantially from 1993 on.

The CHAIRMAN. Well, just to finish my comment.

Over a period of years we have heard projections on deficits in the FSLIC Fund. Now, the BIF Fund. We've heard projections on the deficit that, even though it's rising now, it will come down, in effect, further on down the line. And we've kept moving these targets.

I remember when President Reagan talked about having a balanced budget, I think, back in 1982, when we got started out. Then it was going to be 1983. And then it was going to be 1985. And, of course, we never quite got there.

And you're now saying that we're not going to have a balanced budget by 1995, but we might be down to $100 billion if everything works out. I mean, that's the essence of it. And maybe this time, it's right.

But, I think there's a certain natural skepticism that everyone has these days because our history shows that the projections have always been off, and they've always been on the low side, that the hit to the Insurance Fund's has always been bigger than was foreseen and projected, and the deficits were always larger than were foreseen and projected. We just had an example of that this last week when we had the RTC legislation coming through. The original request was for $50 billion of which $10 billion was just a margin, a safety reserve. They really thought they were only going to spend $40 billion.

Now they're talking about the high end of a range that's $130 billion. And there's no certainty that that is going to capture the problem.

So we've had a succession of disappointments in the forecasts. Now this does not reflect on you. You're held in enormously high regard and esteem by this committee for the work you've done and the objectivity you bring. So there should be no suggestion to the contrary.

Mr. REISCHAUER. And that $50 billion wasn't our estimate either.

The CHAIRMAN. No, I understand.

Mr. REISCHAUER. We were considerably higher.

The CHAIRMAN. I understand.

But, I have to tell you that what we're also hearing from people who are out in the economy---not just in the Northeast where the free-fall is going on. Mr. Larson, who is a member of the RTC Board, as smart on the real estate issue, as skilled, and as much an expert as anybody alive today in this country, has indicated that we've got a national problem in that area.

ESTIMATING THE SIZE OF THE PROBLEM

My guess would be that bank balance sheets are a lot weaker than they look today. I don't think the accounting profession is able to catch these problems in time. We saw that played out in spades in the S&L situation. I think we've got exactly the same problem here.

We had the regulators hovering all around New England--the Bank of New England. Nobody saw it coming. And, lo and behold, we take a giant hit. For, if they had seen it coming, presumably, they would have been taken some actions earlier in the game to limit the damage.

So, my concern is that we may well have more structural difficulty out there—not yet accounted for, because the accounting can't be done on a real time basis and because values are eroding faster than can be calculated.

So, we're dealing with some illusions. Our history has shown that every time we take a snapshot, it's 2 or 3 years late. So, when you have an eroding situation, you're looking at asset values that are actually higher than what they really should be.

And so my hunch is that the Bank Fund will become insolvent, and probably more severe so than what it looks right now. And that's said with no disrespect to you, but is based on the fact that every single forecast we've had in that area over the last decade has come in on the short side.

So, at some point, I think we have to be prepared to broaden out the parameters based on our experience to say that:

Maybe we're not collecting all the facts. Maybe we're not getting all the data in the models.

And so we may have a problem that's really this big rather than this big. [Senator Riegle was gesticulating.]

And I want to make sure that we've got a strategy that's this big because I want to be able to catch the problem in its true size rather than to craft a solution that's for a problem that looks this big, in fact, won't work.

So, that's the concern that I think we have on this committee. And I'm sure it's shared by others.

But, let me yield to Senator Graham.

Senator GRAHAM. Mr. Chairman, I want to say that the colloquy that you have just been having I think was extremely constructive and on point and is forcing us to look at this issue in wider and wider parameters. I sometimes think that we get converted on the day we're elected into a transmission mechanic and asked to deal with the details, and are precluded from stepping back and asking broader questions about destination, mode of transportation and those types of questions.

And in that spirit, it seems to me that we need to look through the issue of FDIC refunding to the question of what it is we want to accomplish after we've accomplished that.

And I would suggest that at least a couple of things we want to accomplish, or one, to increase the amount of credit available in our system, particularly realizing how important that's going to be to energize a recovery from our recession.

And, second, to the maximum extent possible, avoid a taxpayer contribution toward resolving this issue.

I'm also struck with the fact that we have been providing a significant public subsidy to these Deposit Insurance Programs. We've seen in the thrift industry how much of a subsidy FSLIC was receiving and is now receiving in the very large direct taxpayer contributions to the now failed bond. And your comments about the possibility of a subsidy to the FDIC Fund.

I'd like your comments as to what we should be looking for beyond recapitalization. And is there a more effective way to use the public subsidy than the way that we used it with the thrifts? And are using it today with FDIC?

For example, should we be using the subsidy more directly in terms of public participation in the capitalization of financial institutions rather than in understating the actuarial needs of the Insurance Fund?

Mr. REISCHAUER. I would hope that, when viewed over the long run, there would be no public subsidy for the Bank Insurance Fund; that we could get through the current liquidity problem and move on to a longer-run recapitalization without having anything more than temporary borrowing.

Of course, this is premised on the assumption that the situation doesn't snowball. I think there is good reason to believe that that will be the case. If it isn't, obviously, the Congress will revisit this issue and have to make some judgment of the extent to which the taxpayer should come forward.

I might add that all of us in the economy, all of the taxpayers and even the nontaxpayers, benefit from the existence of the deposit insurance system and the fact that it has created a stable banking industry and allowed commerce to flourish in this country. And in certain types of crises—crises that may be caused by external shocks or sudden changes in policies, such as changes in tax legislation that have repercussions on the profitability of investments that were made in the past—it is not altogether inappropriate to turn to the taxpayer for some share of the overall cost.

I don't think we're at that point in this situation. We clearly passed that point a long time ago in the savings and loan fiasco. But, that was, I hope, an experience that we have learned from and that our regulatory institutions have learned something from. And

those institutions are trying to compensate with respect to the situation in the commercial banking sector.

Senator GRAHAM. What recommendations would you have in terms of sensitivity of the Congress in dealing with this recapitalization for getting FDIC through this difficult period as it relates to the longer-term capacity of the banking system to be attractive for capital, or to be able to generate capital within its own retained earnings?

BORROWING AUTHORITY FOR THE FDIC

Mr. REISCHAUER. I suggested in the testimony that the first thing the Congress should do is remove any degree of uncertainty by allowing the FDIC to borrow—so there's no question that funds will be available, and there's no response by the regulators to try and conserve their cash positions.

Then, as the overall seriousness of this situation becomes evident and as the state of the economy becomes clearer—we can sit down and say, well, was CBO correct, was the consensus forecast correct that this was a relatively mild and short recession and the economy is picking itself up. If so, you can proceed to address the problems of both banking regulation and the powers of authorities of banks to go across borders or go into other lines of business, to expand their scope so that they become possibly more attractive to investors in the nonbanking sectors.

Senator GRAHAM. Thank you.

The CHAIRMAN. I have one final question. I appreciate your patience and then I have a final comment for you.

You've suggested that the FDIC needs additional borrowing authority to meet its needs for funds. When we gave the FSLIC unlimited borrowing authority, which we did, it spent $70 billion of taxpayers' funds on just the 1988 deals, without any congressional authorization. We would not necessarily find the same thing happening here, but, if we do move in that direction, should we not put some specific limits on the FDIC's ability to spend borrowed money that we authorize?

Should we put a lid on it?

Mr. REISCHAUER. I suggested a lid of $5 billion or $10 billion more than its current borrowing authority simply because the magnitude of the problem and the nature of the problem might be quite different from what we right now think it is. And if it is, I would certainly think the Congress would want to come back and revisit the whole issue.

Saying you have unlimited borrowing authority is really like saying that this is the mode of operation you should engage in irrespective of what the problem might turn out to be. And I'm certainly sure that this committee wouldn't want to do that.

The CHAIRMAN. So then you do feel that we should put some kind of a lid on it and not just give an open-ended authority here?

Mr. REISCHAUER. I think that would be wise, yes.

The CHAIRMAN. Now, you've given us a lot of important thinking today and a lot of important analysis. And we, of course, have asked you to assist us when we receive the Treasury's proposals on restructuring the financial system. We may hear some of that to-

night in the President's State of the Union Message. I don't know how specific it will get. Maybe they don't even know yet. Probably, some speech writer is struggling with that issue, literally, right now.

But you've offered to help in the analysis of that proposal when it is laid out. And I appreciate that.

We will value your analysis at that time very much. So we thank you for that.

Senator Graham, anything else?

If not, we will be giving you some questions for the record, and we appreciate your testimony today.

The CHAIRMAN. The committee stands in recess.

[Whereupon, at 12:35 p.m., the committee adjourned.]

[Response to written questions follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
ROBERT REISCHAUER

Senator Donald W. Riegle, Jr.

Q.1. You predict that the BIF will experience losses of close to $30 billion over the next 3 years if insurance premiums stay at their present level. Could the FDIC make up that shortfall by raising the premium? How high would the premium have to go? What would be the impact on the banking industry?

A.1. The CBO baseline already assumes that premiums rise to 30 cents per $100 of assessable deposits by 1993. Even with such an increase, the Bank Insurance Fund would not have sufficient resources to meet its needs, particularly in the next two years. Even if premiums were raised more sharply, BIF would have difficulty handling its short-term cash requirements. Such a premium increase could cause additional bank failures and add billions of dollars to bank insurance costs if banks are unable to pass the premium costs on to customers and shareholders.

Under CBO's baseline assumptions, short-term borrowing by the BIF could be paid back out of premium income by 1996, though the fund would still have only limited resources available to cover future failures. A premium in the range of 40-50 cents would build up reserves faster, while probably not jeopardizing a large number of additional institutions. A larger one-time assessment, followed by lower future premiums, would accomplish the same objectives, but might provide better incentives for long-term industry growth.

Q.2. How many banks would be likely to fail as a result of increasing the premiums promptly to 25, 30, or 40 basis points?

A.2. The effect of raising premiums on the financial condition of banks depends greatly on the extent to which banks can pass on their increased costs to customers or shareholders in the form of higher fees, higher interest charges, lower interest rates paid on deposits, or lower dividends. If most of the added costs can be passed on and thus not deplete banks' capital, the number of additional failures would be minimal. If the competitive environment forces banks to absorb the added costs, the number of additional failures would be greater.

CBO cannot predict with precision the impact of premium increases on the number of bank failures. The CBO baseline, which assumes premiums gradually rising to 30 basis points by 1993, encompasses about 750 bank failures over the fiscal years 1991 through 1996. Our rough estimate is that raising premiums immediately to 25 or 30 basis points would result in hardly any additional failures. An increase to as much as 40 basis points would probably add fewer than 10-15 bank failures over the six-year period.

Q.3. The RTC and the FDIC are having severe problems trying to dispose of failed thrift and bank assets. Some people say a private or government-sponsored agency should be established to take over, securitize, and market these assets. What do you think about that idea?

A.3. Rather than creating another government-sponsored agency to dispose of failed thrift and bank assets, it might be preferable to relax certain restrictions on the RTC and FDIC that hinder their ability to dispose of assets. Currently, the RTC and the FDIC are required to sell assets for a "fair market value." Because fair market value changes with market conditions, compliance with this requirement creates an incentive for both the RTC and the FDIC to be cautious--especially so in a market of declining real estate values. Aside from the possible use of some RTC and FDIC assets for programs such as affordable housing, it might be wiser to have the RTC and the FDIC sell assets for whatever price they could obtain.

It might also be more efficient for the FDIC and the RTC to pool and repackage the assets of all bank and thrift resolutions rather than first attempting to sell the assets on an institution-by-institution basis. If assets were pooled, both the FDIC and the RTC might benefit by using private-sector subcontractors to dispose of the assets, or by selling assets directly to private firms. Although some would argue that if private subcontractors or asset disposal firms could sell the assets at a profit, then it would be preferable for the government to handle the sales itself, it is doubtful that the FDIC and the RTC could obtain the same property values, because of differences in incentives.

Q.4. Many experts are saying the nation is over-banked and that consolidation will strengthen the industry and help it keep serving the nation's needs. Do you agree? What should Congress encourage and what should it seek to avoid in the consolidation process?

A.4. It is important to keep distinct two uses of the term "over-banked." The term is sometimes used to refer to overcapacity, meaning that too much physical capital, labor, and other real resources are committed to the banking industry. Rates of return on equity in banking in recent years suggest that this may indeed be a problem. Consolidation per se will do nothing to alleviate this problem, although consolidation accompanied by the liquidation of superfluous banking offices and equipment and layoffs of unneeded personnel could help.

The term "over-banked" is also sometimes used to denote a situation not of excess capacity in the aggregate, but of excessive fragmentation of the industry into too many independent banking organizations, many of which are too small to achieve maximum efficiency. This situation also characterizes U.S. banking, as indicated by studies of economies of scale and by the fact that consolidation usually occurs when such legal barriers as branching restrictions are removed. It is not necessary for the Congress to actively encourage such consolidation; it will occur where it is permissible and when it appears profitable. However, because the increased competition resulting from, say, a sudden elimination of the prohibition of interstate branching might cause serious problems for some inefficient institutions, with resulting costs to the deposit insurance funds, it might be wise to phase such a change in over a period of years. In addition, it might be desirable to couple such a move with increased antitrust scrutiny in order to prevent excessive increases in concentration in particular local and regional banking markets.

Q.5. You stated at our January 29, 1991 hearing that banks holding foreign deposits should pay premiums on those deposits because presently such deposits are receiving de facto coverage under our deposit insurance scheme without paying for it.

Do you favor extending de jure coverage to foreign deposits, or do you favor just assessing premiums on the foreign deposits without formally extending insurance coverage to them? If you don't favor giving them de jure coverage would you favor charging reduced premiums on such deposits in light of the fact that they would not formally be insured?

A.5. It would seem appropriate that the federal deposit insurance system should only extend coverage to those deposits for which an insurance premium is paid. Conversely, it would seem appropriate that a premium be charged for those deposits and other liabilities that are covered by the insurance. If a de facto coverage of foreign deposits continues to be the policy of the deposit insurer, then a compelling argument can be made to have the deposit insurer levy a premium on these deposits. Assessment of foreign deposits is likely to lead to a restructuring of the operations of the major banks that hold most foreign deposits, such that a significant portion of those deposits would escape assessment, but would also no longer receive de facto insurance coverage.

Most industrialized countries now have some formal system of deposit insurance--many of these systems cover deposits of U.S. banks in their countries. Forward-looking changes in the deposit insurance system might take account of this in order to protect banks operating in more than one country from having to doubly insure their deposits. This aspect of international bank regulation requires more study.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DIXON FROM

ROBERT REISCHAUER

Senator Alan J. Dixon

Q.1. Given that BIF needs additional money over the next five years, how much can the banking industry afford to pay? How should economists analyze this question?

A.1. In assessing the banking industry's ability to pay additional premiums, one has to weigh the resources available to the industry (capital and earnings), the risk that some institutions would fail that would otherwise have survived, and the effect of the premiums on the industry's ability to compete effectively with other types of financial institutions.

As of December 31, 1990, banks had total equity capital of $235 billion, of which more than two-thirds was in banks with a capital/assets ratio of 6 percent or more. Draining too much of the industry's capital runs the risk of jeopardizing its ability to survive, since capital is a bank's buffer against future losses. An assessment that consumed 10 percent of the industry's capital would generate $23 billion--the equivalent of well over a year of industry earnings at the 1990 rate. We estimate that an additional 15-30 banks would fail as a result, but that most of the industry's capital would remain in banks with a capital/assets ratio of 6 percent or more.

The long-term level of premiums has a significant impact on the industry's ability to compete, because it affects the pricing of its services and the interest rates it can pay. (It will also affect BIF income, not only directly, but also by affecting the franchise value of banks that go under.) If significant reforms are enacted, it is possible that long-term insurance costs would be smaller than the amounts experienced in recent years, and that high long-term premiums would provide economically misleading incentives to the industry. If so, it may be desirable to assess an up-front premium using an already known assessment base, so as to minimize the distortion of economic incentives. If premiums are levied on future liabilities, for example, they will affect pricing decisions of banks; but an assessment based on past liabilities should not affect such decisions.

Q.2. If banks were assessed $25 billion to recapitalize the BIF, what effect would that have on bank lending and on the economy? How would the effect be different if the assessment were spread out over three or five years?

A.2. A $25 billion assessment slightly exceeds a full year's after-tax earnings for the entire commercial banking industry and is equivalent to roughly 10 percent of the industry's capital. As noted above, some additional banks would be likely to fail and others would experience a worsening of their capital positions. There would be a reduction in lending by these institutions, assuming tight enforcement of capital standards. However, if the Federal Reserve pursued a policy designed to maintain the growth of total bank liabilities, the ultimate result would be that much of the slack in lending by failed and capital-poor institutions would be taken up by healthy banks and by nonbank sources of credit, such as commercial paper and lending by commercial finance companies. There could still be some regional effects, but there need not be a weakening of overall economic activity. Spreading the payments over several years could avoid abrupt curtailment of lending in the short run. However, it would be desirable to determine the size of each bank's assessment at the outset, so that banks' future deposit behavior would not be affected.

Q.3. Currently, interest on the sterile reserves which banks are required to hold at the Federal Reserve is paid to the Treasury. If that interest on bank funds were paid to the FDIC, Treasury revenues would decline but FDIC receipts would increase by the same amount. Therefore, isn't this transfer of funds deficit-neutral?

A.3. Yes, the transfer itself would be deficit-neutral. But once the funds were transferred to the FDIC, they would be available for expenditure, and the spending of those funds would increase the deficit. This type of transaction has the same effect as providing additional appropriations to the FDIC.

Q.4. According to your testimony, approximately 11,000 of the nation's 13,000 banks had more than 6% capital and were profitable for the first half of 1990. These banks accounted for nearly half of the industry's assets. For the same time period, fewer than 600 banks had less than 6% capital and were unprofitable; they accounted for only 10% of the industry's assets. Can you estimate what these figures will be for the first half of 1991?

A.4. We cannot estimate these figures for the first half of 1991. As of December 31, 1990, about 10,600 out of 12,800 banks had more than 6 percent capital and were profitable for the year. These banks accounted for slightly over 50 percent of the industry's assets. The number of unprofitable banks with low capital has grown in the last six months. Almost 700 banks, accounting for about 15 percent of industry assets, had less than 6 percent capital and were unprofitable.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM

ROBERT REISCHAUER

Question: Are there any other levers the Federal Reserve might use to ease the credit crunch?

Answer: Banks borrow from depositors, other creditors, and the Federal Reserve in order to make loans. Another possible lever that the Federal Reserve has to ease the credit crunch is the use of open-market operations to lower interest rates. Open-market operations could directly lower the cost of borrowing by lowering the federal funds rate. Even if banks are currently unwilling to lend, the Federal Reserve could so lower the cost of a bank's borrowing that the opportunity cost of not borrowing to lend would be too high. The Federal Reserve could also encourage lending by lowering the discount rate; however, we are not as confident that this would be as effective as open-market operations.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM
ROBERT REISCHAUER

Senator John Heinz

Q.1. In your testimony (pages 9 & 10) you show CBO's projections of future losses to the bank insurance fund, apparently based on past experience of bank failures. CBO projections appear to be similar to those that a private insurance company might prepare on an actuarial basis to determine their own financial condition.

a) Should the deposit insurance fund be put on an actuarial basis?

A.1.a Actuarial estimation can be used in making budget projections of the deposit insurance funds. This estimation should incorporate both historical experience and projections of future contingencies. This type of analysis is also valuable for determining an appropriate premium level, though projected future needs for funds would have to be weighed against the financial impact of assessments on the banking industry. However, a fundamental problem with applying an actuarial approach to deposit insurance pricing is that the actual losses depend heavily on government policy, in particular on macroeconomic policy and on how long insolvent institutions are permitted to remain open.

b) Is there any reason why the federal deposit insurance system cannot be run like a private insurance system where premiums and reserves are based on solid estimates of potential future claims?

A.1.b The federal deposit insurer could operate more like a private insurer in estimating potential future claims, and perhaps it might better address these expected future losses by changing the way in which it levies premiums. There are, however, limitations in the extent to which the federal deposit insurer can act as a private insurer.

The federal deposit insurance system is actually not an insurance program in the same sense as private-sector insurance. Deposit insurance is the means by which the federal guarantee of certain deposits is conveyed to depositors at "insured" depositories. This makes federal deposit insurance in reality an assurance that certain depositor funds are backed by the federal government. The risk of guaranteeing deposits at banks, thrifts, and credit unions is considered by many analysts to be uninsurable by private insurers. A major problem is that failures tend to be correlated, not independent, since financial institutions are strongly affected by the general state of the economy. However, as we noted in our study, Reforming Federal Deposit Insurance, the government program guaranteeing deposits can be operated very much like private insurance within certain statutory limitations. For example, the FDIC is limited to charging all of its insured institutions the same rate.

c) Are any of the federal insurance programs operated on an actuarial basis? If not, are there any reasons why they should not be?

A.1.c Two examples of federal insurance programs that incorporate actuarial estimates of future income and expense are the Social Security system and the Federal Crop Insurance Corporation. In the Social Security system, premiums are not based on actuarial estimates, but budget projections for the Social Security Fund take into account actuarial estimates of future contributions and payouts. By law, the Federal Crop Insurance Corporation calculates a premium that is supposed to reflect actuarial estimations. Because a portion of this premium is subsidized by the federal government, the portion paid by insured participants does not necessarily reflect the actuarially determined premium. In both systems, the premium charged for insurance probably does not reflect actuarial estimates; however, both systems use actuarial estimates for budget projections.

Q.2. Some industry observers note that banks have been pushed into more risky activities because they have lost many of their more creditworthy corporate customers who can easily access the capital markets. They also conclude that due to severe competitive pressures, banks are not demanding an adequate return on loans to compensate them for higher risks. Of course, this is certainly being proven by banks in the Northeast.

Looking for the cause of these developments, some observers point to the fragmented nature of our financial services industry with thousands of institutions, limitations on geographic expansion and restrictions on products that banks can offer.

a) How would you assess the value of a bank franchise today?

A.2.a It is clear, and confirmed by the behavior of bank stock prices relative to the overall market, that the value of a bank franchise has fallen in the past several years. This is a consequence of many forces: improved information technology that reduces banks' advantages in obtaining credit information; regulatory taxes in the form of capital and reserve requirements that make bank intermediation more expensive than the alternatives, particularly in the market for lending to high-quality corporate customers; interest rate ceilings on deposits that long prevented banks from competing for funds and meeting customers' loan demands when market interest rates rose sharply and led to the development of money market mutual funds; and, to some extent, restrictions on banks' ability to offer a fuller line of financial services. However, the extent of the deterioration in the value of the bank charter can easily be exaggerated. National banks' after-tax return on equity in 1979 was 13.33 percent, the highest in the decade of the 1970s. As late as 1982, the return was only slightly less than the average for the 1970s. In 1983, and for several years thereafter, the average return was well below the average level of recent decades, and it was barely positive in 1987. However, it recovered sharply in 1988 to near-normal levels and, though declining again in 1989 and 1990, remains strongly positive. Moreover, despite its declining market share in a number of types of lending, the banking industry continues to grow in an absolute sense and new banks continue to be chartered.

b) To what extent is the financial condition of the banking industry a reflection of the scope of a bank's charter?

A.2.b To a very limited degree. The displacement of banks as the primary source of short-term credit to major corporations is a secular trend that has been under way for many years and is still in progress. It implies continuous pressure on profit margins and a longer-term shrinkage of the industry, perhaps accompanied by some increase in the failure rate and further consolidation. But that trend is partly a consequence of changes in technology that have eroded banks' informational advantage in lending, and of regulatory actions such as reserve requirements, rather than restrictions on bank activities. The sharp increases in the failure rate and losses to the bank insurance fund that began in the 1980s have largely been short-term phenomena characterized by unusually sharp increases in interest rates, depleted capital, increased incentives for risk-taking, bad loans, forbearance by regulators, and end-of-game plays that have resulted in enormous losses to the insurance fund and taxpayers. It is doubtful that the limitations of the banking charter have contributed very much to these problems. Banks have long since found ways to overcome, albeit imperfectly, the constraints of geographical barriers to expansion--the federal funds market, correspondent relationships, loan production offices, interstate expansion through nonbank subsidiaries of bank holding companies--and recent decisions by the Federal Reserve Board have largely gutted the Glass-Steagall Act. In any case, banks have not found expansion into brokerage and underwriting activities the key to profitability that many of them once anticipated, and many have withdrawn from those markets. Nonetheless, expansion of the permissible lines of business that banks are permitted to engage in could be an important factor in the longer-term health of the industry.

c) In light of the experience with savings and loans, and the current threat to the solvency of the bank insurance fund, there is strong pressure to curtail, rather than expand the permissible activities of banks. Is this a good idea?

A.2.c No. With some important exceptions in the case of savings and loans, and in almost all cases involving banks, institutions have gotten into trouble doing things that they have been permitted to do for decades. Bad loans, not exotic new activities, were the downfall of Continental Bank, most of the banks failing in Texas in recent years, and those New England banks currently experiencing severe losses on commercial real estate loans.

d) What changes in banking activities would you recommend to increase bank profitability, but protect the deposit insurance fund?

A.2.d In order to limit the potential extension of the safety net to broader areas of the economy, it would probably be desirable to limit new activities to those financial, securities, and insurance activities that hold out the promise of important synergies when combined with traditional banking activities and to require that they be conducted by a separately incorporated subsidiary of the bank's holding company. So long as financial firewalls are maintained to prevent draining of funds from the insured bank, and so long as the bank and holding company maintain adequate capital, there is no reason why such an expansion of activities should entail undue risks to the deposit insurance fund.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

ROBERT REISCHAUER

Senator Alfonse M. D'Amato

Q.1. In your previous testimony before this committee on September 12, 1990, you stated that "substantially higher premium assessments would erode bank profits" and that this could "threaten the viability of additional institutions, adding to BIF's case resolution costs and diminishing the assessment base."

What would constitute a "substantially higher premium" that would lead to these results?

How do you think the FDIC should respond to the need for recapitalization of the Bank Insurance Fund?

Do you think that the FDIC should assess an insurance premium on domestic banks' foreign deposits?

A.1. The effect of higher premiums on the financial condition of the banking industry is difficult to assess. If banks could generally pass the additional costs on to their borrowers, depositors, and shareholders, their profitability and capital stock would be unaffected. If, on the other hand, competition from foreign banks or other types of financial institutions would force them to absorb part or all of the increased premium cost, bank profits would be eroded.

There is no clear consensus among experts as to the ability of banks to pass through the costs of additional premiums and as to the consequences these higher costs would have for the industry's future growth. We believe that a premium in the range of 30-40 cents per $100 of assessable deposits would not cause serious problems. A rate in excess of 50 cents might be a cause for concern.

The tangible equity capitalization of Bank Insurance Fund members was about $224 billion on September 30, 1990, and aggregate net income of banks was $14.2 billion in calendar year 1990. An increase from the current 19.5 cent premium to 30 cents would bring in another $2.6 billion a year to the Bank Insurance Fund. If all of the increased cost were absorbed by the banks, the added premium payments would amount to 1.1 percent of their capital on an annual basis and 18 percent of 1990 net income, excluding any resulting tax savings. An increase to a 50-cent premium would roughly triple these percentages.

To avoid risking further disruption to the banking industry, the government could opt for gradually recapitalizing the fund by raising premiums to bring in additional funds over a several-year period. Cash requirements in the interim could be met by borrowing, to be paid off by the higher premiums over a number of years. However, high long-term premiums would diminish the economic incentives for the industry's growth more than a high one-time assessment. Payment of the assessment could be spread over several years if that was easier for the banks. But if the amount was fixed now, it would not adversely affect future decisions by banks.

Currently, the FDIC levies an insurance premium against adjusted total domestic deposits. In the course of resolving failed banks, however, the FDIC has extended insurance coverage beyond the base for which it assesses an insurance premium. This extension of coverage at times has included foreign deposits of domestic banks. It would seem appropriate that the federal deposit insurance system should only extend coverage to those deposits for which an insurance premium is paid. Conversely, it would seem appropriate that a premium be charged for those deposits and other liabilities that are covered by the insurance. If de facto coverage of foreign deposits continues to be the policy of the deposit insurer, then a compelling argument can be made to have the deposit insurer levy a premium on these deposits.

Q.2. As I stated earlier in my opening statement, the estimates for costs of bank resolutions to the Bank Insurance Fund over the next few years ranges from $4.4 billion to $63.4 billion. The Congressional Budget Office estimates losses at $21 billion while the General Accounting Office comes in with the lowest estimate of $4.4 billion - $6.4 billion.

What accounts for the disparity in these estimates of the costs the Bank Insurance Fund will incur in assisting and resolving troubled banks?

How do we reconcile these figures?

How does Congress monitor the condition of the Bank Insurance Fund when the number of potential bank insolvencies is so uncertain?

A.2. The estimates you refer to are not all comparable. In September 1990, the Comptroller General testified that GAO had identified 35 banks that were likely to fail during 1990. Using FDIC's historical loss rates, GAO estimated that the cost to BIF for the failure of all 35 banks would be between $4.4 billion and $6.3 billion. The Comptroller General also indicated that these costs could be significantly understated and that other banks were at risk to fail within the next few years. Thus, the GAO figure should be viewed as a minimum cost for one year only.

In contrast, the other figures represent possible losses over a three- to four-year period. In September 1990, CBO projected BIF losses of about $21 billion over the next three to four years; in today's testimony, we raised that figure to about $30 billion, reflecting deteriorating economic conditions.

The $63 billion figure represents an estimate by Messrs. Barth, Brumbaugh, and Litan of the maximum BIF losses over a three-year period, assuming that the nation (except the Southwest) suffers from a severe "Texas-style" recession. This figure also assumes that the FDIC will not have a policy of forbearance for larger banks and will resolve similarly situated small and large banks with the same frequency; if not, the consultants estimated costs under a severe recession could be as low as $27 billion. They also estimated losses of $19 billion to $43 billion assuming a mild recession; the CBO projection is near the middle of that range.

There is no simple way of monitoring the condition of BIF, given the uncertainties of future failures. The best one can do is to update current conditional estimates as additional information on economic conditions and the real estate market is obtained.

Q.3. What do you think is the likelihood that the Bank Insurance Fund will be recapitalized without taxpayer assistance?

A.3. With a mild recession, we believe the fund can be recapitalized by the banking industry over the next several years through higher premiums or special assessments. Some interim borrowing by the fund is likely to be necessary, but we expect that such borrowings can be repaid without taxpayer resources. This assessment, however, is contingent on the assumption of a mild recession ending by mid-1991 and a recovery to a fully-employed economy by 1996.

Q.4. You stated in your testimony today that, while short term rapid recapitalizations of the Bank Insurance Fund may come from the taxpayer, longer term recapitalization would be financed by the banking industry.

There are several proposals presently circulating that provide for the banking industry to finance the Bank Insurance Fund. Which of these proposals, if any, do you think would provide a workable solution to avoiding taxpayer financing of the BIF?

A.4. The proposals generally involve two forms of financing for the Bank Insurance Fund--additional borrowing authority for the fund and increased payments by the banking industry to the fund. Some combination of the two is probably necessary in order to avoid any taxpayer liability and to minimize the disruption to the industry. Higher industry assessments are essential if the costs are not to be borne by the taxpayers. On the other hand, some borrowing appears necessary because increases in premiums paid by the banks that would be sufficient to cover the fund's short-term cash needs would jeopardize a number of institutions, particularly in the current economic environment. Such borrowing could be linked to a requirement for higher industry payments so as to maximize the probability that the borrowed funds would be repaid without burdening the taxpayers. The least expensive form of borrowing would be from the Treasury; there is no economic or budgetary advantage for BIF in borrowing from the banking industry.

Q.5. In your opinion, what would be the most effective strategies for the Federal Reserve to undertake in alleviating the present credit crunch?

A.5. The Federal Reserve can alleviate the crunch using any of the standard tools of monetary policy. It has already moved to reduce reserve requirements on nonpersonal time deposits, to reduce the discount rate, and to reduce the federal funds rate by supplying additional reserves through open market operations. Some would argue that, because much of the current restriction of credit is occurring at banks that are undercapitalized, simply easing monetary policy would not result in an increase in lending. But this ignores the fact that much, though not all, of the decrease in bank lending has been offset by increases in commercial paper and in lending by finance companies. Increasing bank reserves should ultimately increase the extension of credit through these channels, if not through lending by banks. Assuming this is correct, the assumption that the Federal Reserve has not moved sufficiently vigorously is debatable. To the extent that the credit crunch is temporary and its end difficult to recognize, and given that monetary policy operates with a significant lag, a further sharp easing of policy could entail unacceptable risks of reigniting inflation.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOMENICI FROM

ROBERT REISCHAUER

Senator Pete V. Domenici

Q.1. The Administration and the FDIC project BIF losses at $4 billion for FY 1991, while CBO estimates losses at $12 billion. Can you explain why CBO's projections differ from the Administration's?

A.1. The Administration's 1992 budget projects BIF losses to be $6.1 billion in fiscal year 1991. CBO estimates 1991 losses of $9.1 billion. While the Administration projects higher disbursements for resolving failed banks, it also assumes much higher recoveries from the disposition of assets and thus lower net losses than CBO does.

Q.2. The Administration and the FDIC want the banking industry to replenish BIF, not the taxpayers. CBO assumes in its preliminary baseline that BIF will continue to operate by borrowing for working capital from the FFB. Do you believe the banking industry can recapitalize BIF for working capital and losses without relying on taxpayer dollars?

A.2. It would be difficult for the industry to provide enough resources over the next two years to meet BIF's cash needs. We believe, however, that over the course of the next several years, the industry can cover all bank insurance costs without relying on taxpayer dollars, unless the economy turns out to be significantly worse than we are currently projecting.

Q.3. CBO assumes BIF becomes financially sound in FY 1996 by increasing deposit insurance premium rates in steps from 19.5 cents per $100 of insured deposits to 30 cents by FY 1993. How many banks would fail as a result of increasing deposit insurance premiums as you suggest?

A.3. CBO believes that the premium increases assumed in the baseline would have a small effect on the number of bank failures--probably contributing to the failure of fewer than 10 institutions over the 1991-1996 period.

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